CONTROL BY THE GENERAL MEETING THROUGH THE POWERS TO APPOINT AND REMOVE DIRECTORS: A COMPARISON OF THE LAWS OF U.K., U.S.A. AND GERMANY

RITA EMEH ESEN

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ABSTRACT

This work is a comparative study of shareholders' powers to appoint and remove directors in the United Kingdom, United States and Germany as an internal corporate control mechanism. It highlights the entrenched positions of corporate managers in the face of shareholders' weakening powers in these systems.

Having recognised the importance of shareholders' position as the contributors of corporate capital, the laws of these three systems give them the right to bring about changes in the control of companies by vesting power in the general meeting to determine the composition of corporate boards. Shareholders appoint directors to act on their behalf, the board in turn selects and monitors its executives to ensure that the interests of shareholders and other stakeholders are protected.

The Anglo-American system is characterised by dispersed shareholding and management dominated boards, with the result that shareholders do not exercise their voting rights effectively. Under the German two-tier board system companies are accountable to a wide range of stakeholders and have a different structure of shareholding, where banks control the majority of shares. Despite the absence of management-dominated boards in that system the depository share system together with the practice of co-determination tend to restrict shareholders' participation in corporate control. The reality is that directors may

end up using certain devices to entrench themselves on the board so as to restrict the ability of shareholders to remove them.

This thesis advocates a greater role for shareholders through improved opportunities for them to use their voting powers in determining the composition of their boards. It makes various recommendations in the different areas in which shareholders face difficulties in exercising these powers. It is hoped that the implementation of these suggestions will result in a system which will enable shareholders to exercise their voting powers more effectively for the purpose of controlling their companies.

CHAPTER 1 - INTRODUCTION

" Imagine a system of government in which there are annual elections, but these are almost never contested. Whenever they are, the incumbent government wins by an overwhelming majority....... Changes in the senior leadership do take place, normally through an orderly process of retirement in which the incumbent leaders select and groom their successors........This is not a description of Eastern Europe before perestroika and glasnost. It is a description of the system by which public companies in Britain are controlled and governed."[1]

A. BACKGROUND TO THE CORPORATE CONTROL DEBATE

According to the traditional view of the corporate structure in public companies, shareholders have an important role in corporate control through the exercise of their voting rights to appoint and remove their board members. Owing to the dispersion of shares in public companies among numerous holders, voting has become ineffective as a control device.[2] In private companies things are usually quite different. Members of a private company usually exercise significantly

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1. Davis, E. and Kay, J. Corporate Governance, Take-overs and the Role of the Non-Executive Director, in Bishop and Kay (eds), European Mergers and Merger Policy, 1993, 200 Oxford University Press,

2. The diffused ownership structure does not give individual shareholders sufficient incentive to collect information and discipline managers thus tending to be a less effective governance mechanism. – Griffiths, A., Shareholding and the Governance of Public Companies, in Sheikh and Rees, (eds) Corporate Governance and Corporate Control, 1995, 61, Cavendish Press,.

more active roles in corporate control than their counterparts in public companies. Their main aim in exercising control over the affairs of their company is the protection of their financial investments. The reason for this is that the company is in reality in many cases an "incorporated partnership" in which shareholders contribute their money and labour and expect to participate in the management of its affairs and share in its profits.

With no ready market in which to sell their shares, the only remedy available to disgruntled shareholders in private companies is to seek judicial protection which can be an expensive and a long drawn-out battle. This problem has moved members of private companies to build into their corporate structure protective devices or to enter into binding contracts with regard to the exercise of their rights.[3]

In both private and public companies the right of shareholders to vote has been the primary mechanism for shareholder control over the board of directors. This derives from the general view that as "owners" they are entitled to determine the company's fundamental policies thus having a final say on its destiny, of which board composition plays a vital role. Justifying shareholders' right of control, Clark states :

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3. Examples are disproportionate voting arrangements and shareholders' agreements. See chapters seven and eight of this work for the abuse of these devices.

> "From an economic point of view, there is a strong argument that the power to control a business firm's activities should reside in those who have the right to the firm's residual earnings ..... The intuition behind the argument is that giving control to the residual claimants will place the power to monitor...... in the hands of those who have the best incentive to use the power."[4]

As companies grew larger and shareholding became more widely dispersed the result was that shareholders lacked the incentive to participate actively in company affairs. As members became more passive, they increasingly relied on company management to run their businesses. These increased powers exerciseable by managers create the problem of how to keep management accountable to shareholders so that management powers are not utilised for their own personal gains at shareholders' expense. As far back as the eighteenth century Adam Smith had stated this possibility thus :

> "being the managers of other people's money rather than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own."[5]

In the face of difficulties in exercising their control rights through voting, shareholders discovered another method of exercising some form of control over their company. This power of control came from the ability to sell their

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4. Clark, R.C., Corporate Law, 1986, 389, Blackwell Business

5. Smith, A., The Wealth of Nations, 1776 Reprinted in 1937, pp 699-700, New York : Random House edition

shares and leave the company, which resulted in successive take-over booms such as that of the 1980's.[6] Shareholders would sell their shares to a particular buyer, who would consolidate the voting of the otherwise dispersed shares to replace the board and to take over the company. During such a take-over era management actions and shareholders' reactions were watched closely, and any sign of dissatisfaction on the part of members would bring bidders onto the scene.[7]

B. The Present Debate On Corporate Control

In recent years the issue of corporate control has assumed an unprecedented significance with trends in management behaviour bringing to the forefront of public attention issues concerning the direction of companies and mechanisms of internal control. The dominant role of large companies today has spurred the

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6. Ezzamel, M and Watson R Organisational Form, Ownership Structure and Corporate Performance : A Contextual Empirical Analysis of United Kingdom Companies, 4 British Journal of Management, 1993, 161 at 166-69; Hart, O., Corporate Governance : Some Theory and Implications, 1995,105 Economic Journal, 678, 682-85

7. For the impact of take-overs on corporate control see Lipton, M. and Panner, M., Take-over Bids and United States Corporate Governance, in Prentice and Holland, Contemporary Issues in Corporate Governance, 1993, 115, Oxford - where they state that take-over bids were once considered to be the most effective means by which corporate management could be held accountable for their performance; See also Peacock and Bannock, Corporate Take-overs and the Public Interest, Chapter 4, (Aberdeen, 1991), Chapter 4; Also Charkham J., Keeping Good Company, 1995, 308, Oxford University Press, – where he states that when a company is thought to be badly run over time, its share price declines and provides an opportunity for purchasers to acquire it and make better use of the assets.

interest of different groups in questioning who exercises final control in a company and how that control is employed in meeting a company's goals.[8]

There have been increasing concerns over corporate board policy-decisions and rewards of top managers with the effect that the structure and composition of boards of directors have come under tremendous scrutiny.[9] With the subjects of management misconduct and corporate failures having become issues of extensive academic, media and public attention,[10] it is not surprising that there is now a growing focus on management supervision. This has necessitated reconsideration of board composition and its representation of shareholders' interests. A number of key areas have formed the core issues in the present debate on corporate control.

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8. An effective corporate control system should provide mechanisms for restraining directors from abusing their powers to ensure that they act in the best interest of shareholders, stakeholders and the company at large. - Sheikh S. and Chatterjee, S., Perspectives on Corporate Governance, in Sheikh, S and Rees, W (eds). Corporate Governance, Corporate Control, 1995, 5, Cavendish.

9. Blair, M. M., Ownership And Control, Rethinking Corporate Governance For The Twenty First Century, 1995, 77, The Brooking Institution, where she states that the present corporate governance debate revolves around questions on what non-executive directors should do and whose interests they should serve while they are on the board.

10. Kay, J. and Silberston, A., Corporate Governance, Aug. 1995, National Institute Economic Review 84-97; Geraldine Fabrikant, The Paramount Deal, New York Times, Dec. 23, 1993, p. A1; Kelly, G., Kelly D., and Gamble, A., (eds) Stakeholders Capitalism, 1997, 48, Basingstoke : Macmillan Press Limited.

1. Ownership Structure

There has been much emphasis on greater involvement by shareholders to bring pressure to bear on the management of their companies. Any attempt by individual shareholders to monitor managers is an expensive and difficult issue due to the collective action and "free rider" problems. As other shareholders can take a free ride on the monitoring efforts of any one shareholder, no individual shareholder has sufficient incentive to expend the necessary resources in monitoring management. The result is that the cost of individual shareholders' action is high and unlikely to result in commensurate reward. Emphasising this position Fischel states :

> "because no compulsory cost-sharing mechanism exists for shareholders wishing to oppose management policy, and because no single shareholder can capture the whole gain to shareholders generally from the proposal's defeat, there will be insufficient incentive to organise opposition."[11]

Under the German system ownership concentration is significantly higher than in the Anglo-American system with the largest five shareholders holding an average of over 40%.[12] The result is that shareholders are likely to have a large enough stake in their company to justify investing the resources and time

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11. Fischel, The Corporate Governance Movement, 1982, 35 VAND. L. REV. 1259 at 1277

12. Demsetz, H and Lehn, K., The Structure of Corporate Ownership : Causes and Consequences, 93 (6) Journal of Political Economy 1155 at 1169.

required to collect information and exert the necessary control over management.

One of the criticisms which has emerged is that shareholders in the United Kingdom and United States are only interested in short-term gains, which is often seen as the cause of take-over activities in these two systems.[13] This short-termism of Anglo-American shareholders is based on the general notion that a company's primary purpose is to make profit and distribute dividend to members. In such a situation the company will be under pressure to pay dividends every year even when corporate profits are low with the effect that long-term goals, such as re-investment and expansion, suffer.[14]

On the other hand German shareholders have operated under a different regulatory and cultural background with entirely different expectations. The presence of committed, long-term shareholders protects German companies

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13. Dimsdale, N., Restoring Corporate Accountability, in Dimsdale, N and Prevenzer, M., Capital Markets And Corporate Governance, 1994, 25-26, Clarendon Press.

14. Marsh, P., Short-termism on Trial, 1990, 32, London, where he states that companies generally adopt short-term strategies in an attempt to maximise short term performance to suit the wishes of fund managers and shareholders.

from short-termism experienced by their Anglo-American counterparts.[15] The dispersed and distant shareholders, to whom U.K. and U.S. managers are accountable, judge companies on the basis of financial information which does not always provide an accurate reflection of company performance. In the words of Roe :

> " ....long-term information needs constant private interaction, in which a motivated group of stockholders ask for predictions and see how they pay out over years. Distant shareholders with small blocks cannot readily be part of that kind of ongoing evaluation."[16]

There has been a general appeal to institutional investors in these systems to play a more active role in corporate control on the basis of their concentrated holdings. The argument has been that if institutions step into the corporate scene, their activities may alter the notion of shareholder passivity.[17] The interests of institutional shareholders are not normally contrary to those of individual shareholders as the two categories have a common goal: to get the maximum returns from their investments.

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15. Commenting on the German long-term strategy of corporate control Parkinson emphasizes that their system of control depends on a stable long-term investor and creditor relationships with the company. - Parkinson, J.E. Corporate Power And Responsibility, 1993, 150, Clarendon Press.

16. Roe, M., Strong Managers, Weak Owners, 1994, at 241, Princetown University Press.

17. Wright, S., Two Cheers For The Institutions, 1994, 12-13, The Foundation Pub.

2. The Stakeholder Concept

The central proposition at the heart of the stakeholders approach is that the purpose of a company should be defined more widely than the maximisation of shareholder investments alone.[18] It holds that there should be some recognition of the well-being of other groups that have some form of association with the company, and so an interest or 'stake' in the long-term success of the company. These groups are usually taken to include employees, creditors, suppliers, customers and shareholders.

Proponents of the stakeholder model have pointed to the fact that companies which develop a reputation for the ethical treatment of their employees, creditors, clients, suppliers and customers are able to build up relationships based on trust. This in turn brings about mutually beneficial exchanges and profitable investments to companies. Charkham made this point clearly when he stated :

> "Shareholders are one set of stakeholders among several, and German management thinks of its customers and employees first. The orientation and consensus matter, for

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18. Jones, T. M., Instrumental Stakeholder Theory : A Synthesis of Ethics and Economics, 1995, 20 Academy of Management Review, 404, 421-425

> they underly so much of the German approach to corporate governance."[19]

Under German law, therefore, a company is regarded as an autonomous enterprise having a public and social dimension with a lot of emphasis being placed on the different interests recognised by the company.[20] The interests of stakeholders, in particular those of employees, receive consideration in management decision-making. Since the success of a company depends, in most cases, on the contribution of employees, the case for recognising their importance becomes a valid one.

This runs counter to the traditional Anglo-American practice which focuses on maximising returns to shareholders and argues that shareholders, as owners, are free to exercise their ownership rights in a way that maximizes their own interests without being subjected to any responsibilities.[21] This was the general

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19. According to Charkham profits to shareholders on their investment is "not the be all and end all". He goes on to argue that although consistently poor profits and depressed share prices would reflect on the competence of management yet shareholders' immediate value is not the main purpose of a company. - Charkham, J., Keeping Good Company, 1995, p. 10, Oxford University Press.

20. Kay and Silberston, Corporate Governance (1995), National Institute Economic Review 84 at 86; Ireland, P., Corporate Governance, Stakeholding And The Company : Towards A Less Degenerate Capitalism, 1996, Journal of Law and Society 287, 297.

21. North-West Transportation v. Beatty (1887) 12 A.C. 589.

view held until the second half of the 1980s when it was called into question. It is now thought that simply focussing on shareholders interests is too narrow a perspective as there are other groups who also have interests in the company.[22]

3. The Supervision Of Management

In theory company structure in the Anglo-American system is one whereby shareholders appoint members of the board who in turn choose the executive directors from amongst themselves.[23] In this system the chief executive officer is usually the key figure with the power to make executive policy-decisions. The chairman sets the agenda for board meetings and must conduct such meetings in a manner that enables those present to give their honest views.

The Chief Executive Officer (CEO) may also be the chairman of the board which multiplies the powers held[24]. In Germany the Chief Executive Officer does

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22. Lipton and Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors ,1991, 58 Chi. L. Rev. 187 at 224.

23. Short, H., Non-Executive Directors, Corporate Governance and the Cadbury Report: A Review of the Issues and Evidence, 1996, Corporate Governance, 123 at 127-8.

24. Charkham, J., Keeping Good Company, 1995, 267, Oxford University Press where he states that the Chief Executive Officer has considerable powers and responsibilities which become onerous when combined with the position of chairman of the board.

not normally enjoy such a prominent status. The positions of CEO and Chairman of the Board are, by virtue of the two-tier board system, held by different persons. In that system the management board is the equivalent of the executive directors while the supervisory board, which represents shareholders and employees, monitors the management board.[25]

In the Anglo-American system both the executives and non-executive directors have legal responsibilities for the collective management and decision-making of the company's business for the benefit of its shareholders. The result is that the unitary board has two incompatible functions. First, the board is legally responsible for planning and carrying out business decisions in the company. Second, the board has crucial monitoring functions, being the primary body through which managers are made accountable to shareholders.

On this dual role Ezzamel and Watson have clearly emphasized that:

> " First, the board is the enterprise's supreme executive body. It is legally responsible for formulating and implementing business strategy on behalf of shareholders and for ensuring that all business activities are conducted in a manner which complies with company law and other legal requirements. Secondly the board has crucial governance function to perform. The board is

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25. The practice in companies with more than 2,000 employees is for half of the members of the supervisory board to be elected by employee and in companies with less than 2,000 employees the proportion of employee representatives falls to one-third - Owen, G., The Future of Britain' Boards of Directors: Two Tiers or One, 1995, 11, London: Institute of Chartered Accountants in England and Wales.

> the primary institutional mechanism by which shareholders render the executives, appointed to manage the assets on their behalf, accountable for their stewardship."[26]

Shareholders, on their part, have the right to vote at the Annual General Meeting (AGM) to appoint and/or remove from office any or all directors and to determine the conditions of their employment. The structure of the board and its independence of management will, therefore, affect the degree of control exercised over corporate management. This is largely governed by the rules and regulations of a country's corporate law and differences therein are likely to lead to differences in the board's ability to oversee corporate policies and management.

In the Anglo-American system the primary monitoring element is the existence of independent non-executive directors on the board. Non-executive directors have been recognised as having an important role to play in the supervision of corporate management, and are thought of as being in a position to represent the interests of shareholders on the board. While non-executive directors have been regarded as a means of strengthening shareholders' voice there is doubt

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26. Ezzamel, M. and Watson, R., Wearing Two Hats: The Conflicting Control And Management Roles of Non-Executive Directors, in Keasey, Thompson and Wright, (eds), Corporate Governance, Economic, Management and Financial Issues,1997, 54, Oxford Press.

whether they may be in a position to play this role.[27]

Apart from the fact that non-executive directors may be denied access to relevant information with which they are supposed to monitor and evaluate their executive colleagues, the selection and appointment of non-executive directors are mostly effected by the Chief Executive Officer who leads the group to be monitored. On these grounds the Cadbury Report recommended a formal process for the selection of directors and emphasized the importance of unbiased monitoring of corporate management by the board of directors. To this effect it recommends the appointment of a significant number of independent non-executive directors to corporate boards.[28]

Under the German two-tier board system the supervisory board monitors and controls the activities of the management board and has the power to appoint

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27. Charkham has put the position succinctly thus ' a non-executive will often feel alone, fearful of raising what seems an obvious point or checking a basic assumption which everyone else treats like the laws of Medas and Persian.' - Charkham, J., Keeping Good Company, 1995, 270, Oxford Press.

28. Para 4.30 of the Final Report of the Committee on the Financial Aspects of Corporate Governance, 1992, London : Gee & Co.; Parkinson argues that the precise content of the duty of non-executive directors is obscure as the details of their monitoring role have not been clearly articulated by the Report. - Parkinson J.E., Corporate Power And Responsibility, 1993, 99, Clarendon Press. Although the system relies so much on non-executive directors, they may not always be in a position to give an independent opinion of corporate policies.

members of the management board and remove them for just cause.[29] In Germany, a large part of internal control is by "insiders", mainly through large institutions such as banks. German banks exercise significant voice within companies through the depository share system, representation on supervisory boards and interlocking directorates.[30]

In practice, however, the executive boards are not really as accountable to the supervisory boards as it would appear. The executives have considerable freedom to manoeuvre and although the supervisory boards have a right to demand additional information, the flow of information to them is sparse.[31] These criticisms of both the Anglo-American and German systems of corporate control have resulted in moves to improve corporate control mechanisms in recent times.

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29. Alexander, I. and Mayer, C., Banks and Securities Markets : Corporate Finance In Germany And The United Kingdom, Journal of the Japanese and International Economies, 4 at 11.

30. German banks can vote such depository shares which give them significant power at general meetings of shareholders. According to Baums, banks collectively represent more than four-fifths (82.67 per cent) of all votes present in meetings with the big three banks accounting for 45 per cent of the votes present. - Baums, T. , Takeovers Versus Institutions In Corporate Governance In Germany, 9-11 Sept 1992, 8, Oxford Law Colloquim.

31. Prodhan, B., Corporate Governance And Long-Term Performance, Oct. 1993, Vol.1 Part 4, Corporate Governance: An International Review, 176

4. Disclosure Of Corporate Information

For shareholders to be in a position to vote at general meetings in an informed manner they require sufficient information to assess the performance of their boards. The traditional methods which seek to secure accountability have been the stipulations that certain information has to be disclosed to shareholders and that certain matters have to be approved by them. These methods can only be effective if the boards actually disclose the relevant information and the shareholders understand the information disclosed. Even when the board has disclosed adequate information to the general meeting, shareholders will only be able to influence decisions where they hold sufficient shares in the company to vote effectively.

This role of shareholders in rendering accountable those who manage the affairs of their company has been an important theme in the present corporate control debate. It has, however, been argued that given the cost of making himself informed to vote intelligently, the minimal impact of his votes and the possibility that other shareholders may simply take a free ride on his effort, shareholders are seriously hindered from making their boards accountable for their performance.[32] The corporate control system should ensure that in exercising its

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32. Black, Shareholder Passivity Re-examined, 1990, 89 Mich. L. Rev. 520

discretion management is accountable for its decisions and actions so that the necessary standards are maintained and the appropriate remedial actions can be taken in the event of failure. The emphasis has, therefore, been that company boards should comply with financial reporting and other disclosure requirements that are stipulated under company law.

Without adequate information regarding the performance of management, shareholders' voting rights become meaningless. The present debate stresses that company law has set out the standard by requiring the board to produce and make available to shareholders independently audited financial statements.[33] Commentators in this debate are of the view that despite statutory information and financial disclosure requirements, the system is unable to prevent a determined board from adopting reporting practices which hinder accountability to shareholders. It is against the background of this present debate that this research has been undertaken.

C) Aims Of The Research

The debate on corporate control is based on the concern that company law and practice leave excessive powers in the hands of management who abuse them

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33. Smith, T. Accounting For Growth. 1992, 25-28, London: Century Business; O'Sullivan, N., Auditors' Liability: Its Role in the Corporate Governance Debate, 1993, Accounting and Business Research, 23/91A, 412-20

by serving their own personal interests. This study aims at analysing the powers of the general meeting to appoint and remove directors as internal corporate control mechanisms to curb this improper use of power in three systems – United Kingdom (U.K.), United States (U.S.) and Germany thus providing an international dimension to the current debate.

It examines the inadequacies of the traditional constraints on management while highlighting the entrenched positions of corporate managers in the face of shareholders' weakening powers. It questions the exercise of these powers to fulfil the purpose for which they are intended: keeping management under check to ensure that their actions align with the interest of shareholders.

It discusses the possibility of dispersed shareholding, especially in the Anglo-American system, operating to weaken these powers with the result that devices such as proxy voting and shareholders' voting agreements, which were meant to give shareholders some degree of control in their company, may be used by management to perpetuate their positions on the board. Under the German system, employee representatives sit on the supervisory boards of companies that are subject to co-determination. This work sets out to examine whether the German co-determination system has affected shareholders' powers to control their company. The research also aims to put forward a number of recommendations for the purpose of strengthening the position of shareholders in controlling their companies.

D) Methodology

1. A Comparative Study

The main thrust of the research consists of a comparative study of the controlling powers of shareholders to appoint and remove directors within three systems namely, the United Kingdom, the United States and Germany. A study such as this uses, as its principal methods, the comparison of legal systems, fundamental principles of law and institutions as between various countries (or indeed within the same country: comparative municipal law).[34]

Cross-societal research which tends to combine prevailing and developmental approaches has been one of the theoretical formulations in the social sciences.[35] The importance of comparisons cannot be overstated. With the development of modern methods of communication, distances have shortened with a resulting facilitation of improved relations between states. This has brought about a growing interest in comparative law especially in the commercial field.

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34. Szabo, Law Theory And Comparative Law, 1972, 23 International Journ. of Comparative Law, 13

35 Merritt, R.L. and Rokkan, S. (eds) Comparing Nations, 1963, 10, Yale University Press;

Comparisons help one to obtain a better understanding of one's own system when seen from the perspective of other systems. Through a comparative study one is able to recognise those legal rules, regulations and social institutions which shape the special characteristics of a system. This, in turn, gives a clearer view of the gaps and weaknesses which familiarity may have led one to overlook. This awareness may result in appropriate steps being taken to make improvements and implement changes where they are most needed.

In the heat of the present corporate control debate an observer of the international scene is bound to ask some important questions, for examples:

i) What are the reasons for the dramatic differences in the corporate control mechanisms in different countries?

ii) Is one system of corporate control more effective than others?

iii) If so why can the practices of that system not be adapted by others?

By subjecting rules, regulations and practices of companies in the United Kingdom to comparisons with those of the United States and Germany and vice versa, it is hoped that these systems will benefit from the innovative ideas of others as cross fertilization of ideas should occur. An overview of corporate law and practice in the United States[36] is invaluable to a clearer understanding of the

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36. Particularly the emphasis on board committees, the regulation of proxy voting, and the courts' attitude towards contracts by common directors of competing companies.

loopholes of U.K. system. The fact that pressure can be brought to bear more readily on companies by German financial institutions is instructive to the United Kingdom where large financial institutions, despite their growing pre-dominance in share-ownership, have not taken adequate steps to control the running of companies.

A comparative legal study of this nature shows that the differences between countries are not accidents of history and politics but the results of differences in the legal and regulatory environments. While companies in the Anglo-American system, with their dispersed shareholders, may rely on the threat of take-overs German companies are, to a large extent, controlled by banks with which they have close ties.[37] Although a U.K. company based in the U.K. is subject to the laws of that system, its subsidiaries in Germany and in the U.S. would be subject to the laws of those systems. This makes an understanding of the dynamics of other systems an important issue in the present globalisation of commercial activities.

In the context of the on-going international debate on corporate governance a comparative study of this nature should prove highly informative on a wide range

37. Cosh, A. , Take-Overs And Short-Termism In The U.K., IPPR Industrial Policy Paper No. 3 (1990), 8; Schneider-Lenne, Corporate Control In Germany, (1992) 8(3) Ox. Rev. Econ. Pol. 11

of issues especially those of board structure, composition and its representation of shareholders' interests. This comparative study has been undertaken mainly through an analytical approach with an evaluation of how effectively shareholders actually exercise their power to determine the composition of company boards.

2. Analytical Approach

In order to obtain a clear picture of the exercise of shareholders' power to control their companies an awareness of the legal rules, regulations and corporate practices of these three systems under study becomes necessary. To this effect an analytical approach has been adopted within the main body of the research which takes each of the systems in turn. Under this analysis extensive literature on the current corporate control debate has been used in the different chapters while examining shareholders' control through the exercise of these powers.

The way executive directors are made responsible to the board and they, in turn, to shareholders has become a heated debate. The analysis seeks to shed some light on the various devices which, although meant to aid shareholders in controlling their companies, have been converted into tools which enable directors to entrench themselves on corporate boards. The resulting inconsistencies of legal rules (and regulations) and the practice have been emphasised.

3. Evaluation

First, there has been an evaluation of the structure and composition of boards of directors in the three systems. The research posits that in the unitary board structures of U.K. and U.S. there is the tendency to concentrate authority, in large companies, in corporate managers with whom shareholders have little direct contact. With boards being dominated by executive directors the difference between the board and management tends to disappear. In evaluating the structure and composition of U. K. boards recognition has been given to the fact that since all directors bear equal responsibilities for the operation of the company, this makes it difficult for non-executive directors to monitor effectively the activities of the executive team.

The German two-tier board, on the other hand, ensures that the monitors are not required to share the responsibilities of management decisions with the executives. An evaluation of the unitary board has also shown the dilemma of that system where the roles of the chief executive officer and the chairman are sometimes combined. One of the functions of the chairman being to dismiss the chief executive when necessary, such removal becomes impossible where the office is combined with the chairmanship of the company.

The second evaluation has been in the area of shareholders' exercise of their powers. This thesis indicates that by posing searching questions, shareholders could cause some discomfort to management and even effect changes to their boards. Its evaluation is, however, that very few shareholders behave in this way which leaves dissatisfied members with the option of selling off their holdings. There appears to be more dialogue between the owners of German companies and their management with major shareholders being able to express their views through the forum of the supervisory board.

As the present debate emphasises the need for accountability of corporate management, there is a strong case for reviving the traditional system of corporate control by stipulating rules which clearly define boards' responsibilities to shareholders. An evaluation of the present position shows that proposed reforms[38] should not only be in the form of self regulatory codes which companies can choose to ignore. On this basis the thesis puts forward some proposals on how changes may be made for the purpose of improving the chances of shareholders who wish to determine the composition of their boards.

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38. In the form of the Cadbury Report, the Greenbury Report and the Hampel Report in the United Kingdom; The ALI Corporate Governance Project in the United States and the Reports of the German Monopolis Commission.

4. Sources Of Information

In order to identify, analyse and evaluate the legal issues involved this work has made extensive use of published legal resources from different sources. The legal materials used can be sub-divided into three broad categories: primary sources, secondary sources and finding tools. The primary sources of information used for this research are provisions of codified and statue law, constitutional provisions, legislative materials, decisions of courts and arbitration. Being authoritative rules of governmental bodies these primary sources have helped to identify significant issues thus providing the legal basis for the analysis.

Secondary sources have been used to obtain important background information and a general overview of this area of law. These have consisted, in the main, of materials which have explained, interpreted, developed and criticised the primary sources. The main types used have been scholarly treatises, textbooks, law reviews and other legal periodicals, legal encyclopaedias and literature in the mass media. These have all been invaluable in the analytical aspect of this work.

Finding tools have been extensively used to locate primary and secondary sources. These have been in the form of digests, annotations and legal periodical indexes. Computer data bases such as LEXIS and WESTLAW have been extremely useful finding tools in accomplishing this research.

E) The Structure Of The Research

The implications of the separation of ownership and control have made the job of supervising corporate managers a difficult one. According to the shareholder model of the Anglo-American system the main objective of managing a company is the maximisation of shareholder's value while the German stakeholder approach emphasises a wider constituency with due consideration being given to employees and trade relationships. The different aspects of this research have been examined as follows:

Chapter two of this work discusses the main control mechanisms in the three systems under study. It examines how directors' actions are monitored to ensure that the interests of shareholders and other stakeholders are protected. Chapter three addresses the influence of institutional investors on shareholders' powers to appoint and remove directors. It posits that the active participation of this category of shareholders on the corporate control scene gives the hope that shareholder control over management may become a reality.

Rules and regulations being some of the main causes of the differences in control systems, chapter four examines the statutory and regulatory rules which enable shareholders to appoint and remove directors under United Kingdom, United States and German laws. It reviews the limitations that are inherent in these different systems' frameworks which restrict the exercise of these powers.

Chapter five starts by focusing on the structure of corporate boards in the United Kingdom, United States and Germany. It explores the extent to which employee representation on the boards of German companies may affect the powers of shareholders to appoint and remove directors. The chapter concludes by evaluating the strengths and weaknesses of the unitary and two-tier board structures.

Chapter six evaluates the mechanism of proxy voting and questions whether this practice ensures shareholders of any input in the composition of their boards. While the issue of disproportionate voting share is not the norm in the systems under study, the attachment of disparate voting rights to shares is still being practised. Chapter seven examines the effect of disproportionate voting rights of shares on the property right of shareholders in general and their rights to appoint and remove directors in particular.

Chapter eight reviews the mechanics of shareholders' voting arrangements while examining the potential of these devices being used to deprive shareholders of any significant role in their companies. Where executive directors of one company serve as non-executive directors of another this can foster mutuality of interest and affect the independence of the non-executive group. Chapter nine of this work focuses on the implications of interlocking directorates on companies. It examines the effect that such inter-linkages of board membership have on the controlling and monitoring roles of non-executive directors for purposes of protecting shareholders' interests.

Recognising that each system has its advantages and disadvantages the final chapter concludes that it would be futile to attempt a convergence of the practices of these different systems. It rounds up the work by making a number of suggestions on the areas where rules and regulations could bring about a more meaningful exercise of shareholders' powers to appoint and remove directors.

CHAPTER TWO

INTERNAL CONTROL IN THE LEGAL STRUCTURE OF A COMPANY

A) INTRODUCTION

Individual shareholders now own only a small portion of the total shareholding in public companies and so lack the level of interest that justifies serious involvement in their companies.[1] Instead they hire agents (directors and officers) to manage their funds on their behalf. The separation of ownership and control has been the driving force behind the development of the corporate governance movements in different jurisdictions.[2] The central problem in the management and control of companies is how to ensure that management does its best to pursue a profit maximising strategy on behalf of shareholders and other corporate stakeholders. [3]

Ayer had summarised the position as far back as 1863 when he stated:

> " The present stockholders are scattered all over New England , and other States. They have bought their shares as an investment with the delusive hope that somebody is interested in the company who can and will take care of the company ."[4]

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1. Davis, P, Institutional Investors In The U.K., in Prentice & Holland (eds), Contemporary Issues In Corporate Governance, 1993, 74, Clarendon, where he states that in large companies the need for capital has led to a situation in which no one individual shareholder holds a significant block of shares to be able to hold management accountable.

2. Prowse, S. Corporate Governance In An International Perspective (1994), 36

3. Dooley, Two Models of Corporate Governance, 47 Bus Law 461, 465 (1992); Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 705 (1982)

4. Ayer J. C, Some of the Usages and Abuses in the Management of Car Manufacturing Corporations 3 (1863) , Waterman.

There was widespread concern even then that the board of directors would not have sufficient incentives to do the job of protecting shareholders' interests. An 1877 editorial in the New York Times provides an equally precise commentary :

> "The old relations between directors and shareholders, between managers and the public , exist no longer. The power incident to a directorship is used most frequently for the furtherance of interests...... which indeed are often antagonistic to shareholders interests."[5]

These concerns about the ownership structure and the relationship between managers and shareholders were more elaborately articulated over 50 years later by Berle and Means.[6] They claimed that shareholders were merely passive owners and asserted that in large public companies management was not chosen by shareholders but rather was a self-perpetuating oligarchy. According to them:

> " Ownership is so widely scattered that working control can be maintained with but a minority interest. Separation becomes almost complete when not even a substantial minority interest exists ...... Under such conditions control may be held by the directors who can employ the proxy machinery to become a self - perpetuating body even though as a group they own but a small fraction of the stock outstanding ..... In the corporate system the "owner" of industrial wealth is left with a mere symbol of ownership while the power, the responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control ."[7]

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5. Corporate Management, NY Times, Feb 2, 1877, at p. 4

6. Berle A. and Means G, The Modern Corporation And Private Property, 1932, (Transaction Publishers Edition, 1991) 54

7. Ibid at 124

Although shareholders' interests may coincide with those of management, there is also the possibility of the two groups having different and even conflicting interests. This potential divergence in interests can result in substantial agency costs which arise from the need to monitor management to keep it on task.[8] The main question is how to keep these costs low. One possible route is to make shareholder monitoring easier through 'shareholder democracy' reforms such as extensive disclosure requirements and the threat of derivative actions against management.[9]

Broadly speaking corporate control refers to the way in which companies are directed and governed. It is the machinery by which management actions are monitored to enhance shareholders' interests and to meet the goals of a company. It consists of a range of control and accountability mechanisms designed to meet the expectations of corporate stakeholders. According to Tricker the concept covers the:

> " practices of boards and their directors, the relationships between boards and shareholders, top management, regulators, auditors and other stakeholders"[10]

Corporate control, therefore, strives to provide a balance between the freedom of management to make corporate decisions and control over those decisions. In any

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8. Agency cost arises due to a divergence in interest between the agent and the principal. The separation of corporate management from ownership results in certain costs which include the cost of contracting the agents and the cost of monitoring and controlling them. - Weston J.F, Chung K.S. and Hoag S.E, Mergers, Restructuring, And Corporate Control. 1990, p. 48, Prentice Hall.

9. Davis E. and Kay J, Corporate Governance, Takeovers And The Role Of The Non-Executive Director, 1990, Business Strategy Review p. 65.

10. Tricker, R.I., Editorial, Jan. 1993, Journal of Corporate Governance, Vol. 1 No.1, Jan (1993) pp1-3

jurisdiction this should compose of :

a) direction, which has to do with the formulation of the strategic policies for the present and future benefit of the company;

b) supervision, which involves monitoring and overseeing management performance; and

c) accountability on the running of corporate business.[11]

It has been argued that since shareholders supply capital and are the main risk bearers in companies they are the best group to exercise control over those who manage their capital - a general concept known as 'shareholder democracy'. This concept has its origin in the traditional view that shareholders are most likely to act as conscientious overseers of those who manage their property.[12] Within the traditional structure shareholders should be able to dictate how the company is to be run by their ability to appoint directors who should operate with the main objective of promoting shareholders' interests.

Companies in different countries are organised in different ways with a variety of corporate control mechanisms. The differences in the legal and regulatory framework are not simply accidental but can be traced back to differences in the social, political and economic backgrounds of the different systems.

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11. Sheikh S. & Rees W, Corporate Governance & Corporate Control, 6, (1995) Cavendish Ltd

12. Smith, A. The Wealth Of Nations, 1778, Book V Ch.1, Part 111 1937, Modern Library Edition, New York.

This chapter brings together and examines aspects of internal control in companies in the U.K., the U.S. and Germany. It discusses the main characteristics of each control system and gives an analysis of their strengths and weaknesses. It examines the powers of shareholders to monitor the actions of directors for the purpose of ensuring that they act in the best interest of the company in the broad sense.

B) CORPORATE CONTROL IN THE UNITED KINGDOM

Under the traditional corporate structure shareholders had the right and power to control the operations of the company. Shareholders were then considered as active participants, and directors were regarded as agents of the shareholders. The general body of shareholders should have some impact on the company to ensure that it is well-managed and complies with proper principles of corporate governance.

This traditional position was reflected in Section 90 Companies Clauses Consolidation Act 1845 which stated:

> "The directors shall have the management and superintendence of the affairs of the company, and they may lawfully exercise all the powers of the company, except as to such matters as are directed by this or the Special Act to be transacted by a general meeting of the company; but all the powers so to be exercised shall be exercised in accordance with and subject to the provisions of this and the Special Act; and the exercise of all such powers shall be subject also to the control and regulation of any general meeting specially convened for the purpose, but not so as to render invalid any act done by the director prior to any resolution passed by such a meeting."

The interpretation of Section 90 was elaborated upon by the Court Of Appeal in Isle Of Wight Rly Co. v. Tahourdin[13] where Cotton L. J. stated that shareholders should not be prevented from holding company meetings if such meetings were the only way they could influence corporate policies.[14] Section 90 was later replaced by Article 80 of Table A to the Companies Act 1948 which was generally interpreted to mean that shareholders could exercise control over their directors' management powers by passing a special resolution at general meeting.

Article 80 itself was replaced by Article 70 of Table A[15]. The effect of Article 70 is that shareholders cannot interfere with management's exercise of its powers unless they give directions by special resolutions at general meetings[16]. Members, however, have certain power over the affairs of their company, exercisable by them through their right to vote on resolutions, of which the most important are the rights to appoint and remove directors.[17]

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13. (1883) 25 Ch.D. 320

14. Also Exeter and Credition Rly v. Buller (1847) 16 LJ Ch 49 where the court held that the powers vested in the directors were subject to the resolutions of the general meeting, which have the effect of controlling directors' activities.

15. Companies (Tables A to F) Regulations 1985

16. In Breckland Group Holdings Ltd v. London & Suffolk Properties Ltd (1989) BCLC 100 it was held that Article 70 conferred the management of a company's business on the directors and that the general meeting could not interfere with that power.

17. Article 78, Table A and Section 303, Companies Act 1985; see also Sheridan T. and Kendall, N., Corporate Governance, 1992, 54

1. Shareholders' Role In Corporate Control

The traditional model of corporate control separates the functions of those who provide capital (the shareholders) from the directors who manage the company's business.[18] While shareholders have no control over ordinary business decisions their collective interests are represented by the board. Shareholders are supposed to exercise control through their voting for the appointment and removal of directors, approval of fundamental changes, and alteration of the articles. In private companies shareholders rely on their company for their livelihood, and with no ready market for disposing of their shares, shareholders in private companies assume active roles in the control of their companies.

As members of private companies desire some control over their cash and protection of their human investments the participants often operate it in the form of an "incorporated partnership."[19] Members normally contribute their money while managing the business of the company even though the traditional model contemplates a different organisational structure. Where disgruntled shareholders seek judicial protection, such processes, apart from the effect of the business judgment rule, are usually long drawn-out and expensive. These have moved shareholders in private companies to build into their company structure ways of protecting their interests[20].

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18. Article 70 of Table A which vests management powers in the board.

19. Ebrahimi v. Westbourne Galleries [1973] A.C. 360

20. An example is Bushell v. Faith [1970] A.C. 1099

In large public companies with widely dispersed holdings and a market for their shares, shareholders' participation in the appointment and removal of their directors is not so easily achieved as the traditional model suggests. Shareholders' control over corporate affairs, in this type of company has, been significantly diluted.[21] The right to vote, which is meant to be a control device in the hands of shareholders, has turned out to be a mere window dressing. In reality most shareholders do not attend meetings to exercise this right. The normal practice is for them to hand over their votes to individuals often selected by management. This leaves control in the hands of the directors who virtually select their own successors. [22]

In the 1980s shareholders discovered that, despite failures in the use of their voting rights, the threat of take-over gave them some control over their companies. Their power came from the threat to sell their shares as they were able to sell to a particular buyer who would consolidate the voting power of the otherwise dispersed shares, take-over the company and replace the board.[23] This way the threat of take-over provided a means of disciplining management where shareholder voting rights failed.

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21. Prentice, D.D., Aspects Of Corporate Control Debate, in Prentice and Holland (eds), Contemporary Issues In Corporate Governance, 1993, 41, Clarendon Press

22. Chapter six of this work pages 214-217 gives a review of the use of the proxy voting machinery by corporate management.

23. Jensen, M.C, Take-overs: The Causes And Consequences, (1988), Journal of Economic Perspectives, Winter 2 : 21, 34 – where he argues that takeovers serve as important sources of protection for investors.

After the takeover era, a new era began during which institutional investors emerged as a powerful force in the corporate control scene. The power of this group is based on their voting incentive when compared with individual shareholders. With their small stake in companies, individuals shareholders have little time to spend familiarising themselves with the issues involved.[24] Given this information disadvantage it is not surprising that individual shareholders are indifferent to corporate control issues. As institutions have larger stakes in individual companies than individual shareholders,[25] they are expected to play an important role in corporate control since moves by them to sell their shares would drag down the market thus lowering the selling prices.

One of the significant powers endowed on shareholders - the power to evaluate directors and replace under-performers with credible individuals while holding the board responsible to put in place the best managers - has turned out to be less effective than expected[26]. In an attempt to come to the aid of shareholders, U. K. company law has adopted a range of mechanisms with the aim of monitoring

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24. Bain N. and Band D., Winning Ways Through Corporate Governance, 1996, 11, Macmillan Business – where they state that individual shareholders are subjugated to the needs of large shareholders who get the first opportunity to gain new insights and information.

25. Stapledon, G. P., Institutional Shareholders And Corporate Governance, 1996, 107, Clarendon Press – where he indicates that institutions hold a large chunk of equity in U.K. companies

26. Sheikh S. and Rees W. (eds), Corporate Governance and Corporate Control, 1995, 61 Cavendish.

corporate management for purposes of shareholder protection. These include:

1. Mandatory disclosure of corporate information which enables shareholders to decide whether to remain investors of the company.

2. The requirement that certain decisions should be approved by shareholders.[27]

3. The requirement that corporate management's actions should be undertaken only for the benefit of the company as a whole (which includes shareholders as the main stakeholders). In this respect the law imposes certain duties upon directors which define the standard of behaviour expected of them.[28]

In view of these requirements shareholders are expected to determine whether there has been any departure from the stipulated standard and where necessary to take actions to redress such departures. It has, however, long been realised that these strategies are inadequate for each seems to be capable of being controlled by, rather than facilitate the control of, a powerful management.[29] Turning to the first safeguard mentioned, it cannot be over emphasized that management possesses the information that shareholders need. They can influence how that information is collected, presented and released thus management can manipulate the disclosure process. The second safeguard of shareholder approval is also a formality since management controls the proxy voting process and in the face of dispersed

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27. These include the award of long service contracts, (S. 319 CA 1985) substantial property transactions (S 320 C A 1985) and loans to directors (S.330 C A 1985)

28. Regal (Hastings) Ltd v. Gulliver [1967] 2 AC 134; Boardman v Phipps [1967] 2 AC 46

29. Finch, Company Directors: Who Cares About Skill and Care? 1992, 55 MLR, 179

shareholding it can procure almost any shareholder approval it requires.[30] Finally the ratification process enables directors who are also shareholders to cast votes at general meetings to ratify their breach of duty. In the United Kingdom allegations of unchecked managerial abuses[31] have brought about a growing interest in the subject of corporate control with particular emphasis on the role of non-executive directors.

2. The Contributions of Different Committees

As shareholders generally do not exercise their voting rights, they normally have very little say in their company's policy-decisions and the composition of their boards. The Cohen Committee, as far back as 1945, identified the lack of active participation on the part of shareholders and emphasized the need to encourage them to take active involvement in their companies. According to that Committee's report:

> " The illusory nature of the control theoretically exercised by shareholders over directors has been accentuated by a dispersion of capital among an increasing number of small shareholders who pay little attention to their investment, so long as satisfactory dividends are forthcoming, who lack sufficient time, money and experience to make full use of their rights as occasions arise and who are, in many cases, too numerous and too widely dispersed to be able to organise themselves."[32]

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30. Gower, Principles of Modern Company Law, 1992, 5th ed., 512, Sweet and Maxwell

31. Instances such as Robert Maxwell, Asil Nadir of Polly Peck and Ernest Saunder of Guiness are but a few.

32. Board Of Trade, Report Of The Committee On Company Law Amendment, Cmnd 6659, 1945, 135

The Cohen Committee drew the attention of the U.K. business world to the effect of the separation of ownership from control in companies. It insisted that it was desirable to encourage shareholders to consider proposals required by law to be put before them by the directors, and stressed that shareholders should participate actively in overseeing the running of their companies. The Jenkins Committee reporting in 1962 also took the view that, shareholders should be given a reasonable degree of control over their companies.[33]

Under U.K. corporate practice there is the concentration of authority, in public companies, in the board of directors with whom shareholders have little direct contact. There has been a tendency in such companies to increase the proportion of executive directors with the effect that the board is sometimes dominated by the executive team. Where that is the position the difference between the board and management largely disappears - normally referred to as the "inside board".[34]
It is only in recent times that attempts have been made at increasing the number of non-executive directors for purposes of protecting shareholders' interests[35]

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33. Board Of Trade, Report of the Company Law Committee (1962) Cmnd 1749 (' Jenkins Committee') p.3 para11.

34. Davies E. and Kay, J. Corporate Governance, Takeovers and The Role of the Non-Executive Director, Business Strategy Review, (Autumn 1990), 17 at 21.

35. Clutterbuck D. and Waine P, The Independent Board Director: Selecting And Using The Best Non-Executive Directors To Benefit Your Business, 1994, 24, McGraw-Hill; Russell Reynolds Associates, Independent Directors: U.K. Companies, 250 Survey, 1995, at 10;

Some measures have, however, been taken in the U.K. in an attempt to redress the imbalance between the powers exerciseable by management and the representation of shareholders on the board. The Cadbury Committee considered shareholders' role in corporate control to be an important one. It emphasized that shareholders should exercise their control powers and should satisfy themselves that an appropriate governance structure is in place. Giving prominence to these important roles of shareholders, that committee stressed that the relationship between shareholders and directors should be that the shareholders appoint directors who in turn report on their stewardship by accounting to shareholders for their actions.[36]

The report recommended that the roles of the chairman and the chief executive officer be separated by urging that:

> " there should be a clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual, has unfettered powers of decision.[37]

The committee also identified various board level mechanisms as essential for ensuring high quality monitoring of the financial aspects of corporate governance. It stressed the need to clarify the chain of accountability and to build monitoring and

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36. The Committee On The Financial Aspects Of Corporate Governance: Final Report, 1 Dec. 1992 (Cadbury Committee) p.15. This committee's recommendations on the appointment and role of non-executive directors have been discussed in the later part of this chapter at page 46

37. Cadbury A, the Financial Aspects of Corporate Governance: The Code of Best practice, 1992, para. 4.5 – 4.7

control into boardroom and management decision-making processes[38].

Another committee on corporate governance was set up, chaired by Hampel to promote high standards of corporate governance for the purpose of investor protection and in order to preserve and enhance the standing of companies listed on the Stock Exchange.[39] This committee has addressed various areas of company structure. It emphasized that boards' main role is to monitor corporate management while exercising vigilance for their company's welfare. According to this committee, boards have to create an adequate machinery for carrying out the different board functions.

Some of the important recommendations of this committee are:

a. That the board should disclose the non-executives that are independent.[40]

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38. Cadbury, A., Reflections On Corporate Governance, The Chartered Institute of Bankers, 1993; In 1994 there was clear evidence of public concern based on the suspicion that there was some collusion at board level in the fixing of executive remuneration. This study group chaired by Sir Richard Greenbury, came out with a Code of Practice and recommended that the Stock Exchange makes compliance with the code mandatory for listed companies - Para 2.4 of the Greenbury Recommendations. The committee made a number of recommendations which should help to solve the problem of directors awarding themselves huge salary increases which have no links with corporate performance. One of the most important recommendations of this committee is that boards should set up remuneration committees of non-executive directors to determine the company's policy on executive remuneration and specific remuneration packages for each of the executive directors. See para 4.3 – 14.7

39. The Committee on Corporate Governance, Final Report January 1998, London: Gee & Co.

40. Recommendation 9

b. That non-executive directors make up at least one third of the board.[41]

c. That companies' annual reports should identify a senior non-executive director.[42]

These recommendations are all aimed at reducing the risk of mismanagement, fraud and corporate failures but the question is whether companies have actually responded to them. A survey that was carried out after the Cadbury Report has shown that in over two-fifths of cases, appointment of non-executive directors are still made through personal contacts of board members.[43] Short has commented that since it is the executives that actually hire the non-executives, they are unlikely to have any incentive to act in shareholders' interests.[44]

3. Non-Executive Directors

There is a general consensus that control and monitoring should be some of the functions of the board of directors[45]. It is in the exercise of this monitoring function

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41. Recommendation 12; The Cadbury Committee had merely recommended that companies should appoint non-executives of a sufficient calibre .

42. Recommendation 15

43. Intelligence, Pensions Investment Research Consultants (PIRC) April (1993) Vol. 7, No.3, 16, London,

44. Short H., Non-Executive Directors, Corporate Governance and the Cadbury Report: A Review of the Issues and Evidence, (1996), 4/2 Corporate Governance 123 at127

45. Mitchell A. and Sikka P, Corporate Governance Matters, Discussion Paper 24(1996), 2, Fabian Society ; Prentice D.D. and Holland P.R.J. (eds) Contemporary Issues In Corporate Governance, (1993) p. 215 Clarenden Press; Stapledon G.P, Instititutional Shareholders And Corporate Governance (1996) p.12 Clarenden Press

that the main difference between the roles of executive and non-executive directors becomes clear. Executive directors are responsible as managers for corporate decision-making while non-executives should review their performance.[46]

a) Their Role In Corporate Control

The argument has been that by vesting shareholders with the powers to appoint and remove directors the legal and regulatory framework has created a structure responsive to shareholders' interests. The board is granted the power to make important decisions on behalf of the company including that of choosing the company's executive officers, setting executive compensation and reviewing management policies. It has been argued, however, that the board should not only be concerned with financial incentives and remuneration of directors but should create the right environment for all the directors to perform effectively to achieve the company's goals.[47]

The role of non-executive directors has been in the spotlight of the corporate governance debate with numerous proposals put forward for a new improved role for this category of directors.[48] Although the legal system already relies on non-

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46. Cadbury Report supra note 22 at paras 4.4 - 4.6

47. Maw, Lane and Craig-Cooper, Maw On Corporate Governance, 1994, 49, Datmouth Ltd

48. BDO Binder Hamlyn, Non-Executive Directors - Watchdogs or Advisers? (1994) 11; Confessions of a Non-Executive, Fin. Times, 15 July 1991, p.11; ISC, The Role And Duties Of Directors - A Statement of Best Practice (1991); PRO NED, Code Of Recommended Practice on Non-Executive Directors (1987) 89; PRO NED is a body sponsored by a number of leading financial bodies.

executive directors to act as a check against managerial indiscretion,[49] some reformers have recommended that the law should take a step further by requiring that the majority of board members should be independent of management.[50] To be independent they will have to be free from any relationship which could interfere with the exercise of their judgment. In an attempt to enhance boards' ability to effectively monitor there have been calls for an increased numbers and more active presence of non-executive directors on boards and key board committees.[51]

One of the main recommendations of the Cadbury Committee was that companies should appoint unbiased non-executive directors to protect the interest of shareholders. The committee believed that the independent judgment of this category of directors should raise standards of good corporate governance. It also recommended that there should be a minimum of three non-executive directors, two of which should be independent of the company.[52]

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49. The rationale for this reliance on outside directors is that since they do not have personal financial interests in retaining management they can ensure that the company is run in the long-term best interests of the shareholders

50. See Rosenstein S. & Wyatt J, Outside Directors, Board Independence, and Shareholder Wealth, 26 J. FIN. ECON. 175 (1990); PRO NED, Research Into The Role Of The Non-Executive Director: Executive Summary (1992) 6.

51. It has been widely recognised that the boards of directors of U.K. companies are generally dominated by executive directors. A 1992 study by Hemmington-Scott of 1,612 commercial and industrial listed companies found that on average 63 per cent of board members were executives and that the majority of the non-executives were actually executives of other listed companies - Hemmington-Scott, Non-Executive Director Statistics, Corporate Register (Mar. 1992) , Hemmington-Scott, 5-9;

52. See The Committee On The Financial Aspects Of Corporate Governance: Final Report, 1 Dec. 1992 p. 15, (London: Gee & Co.)

b) The Issue Of Independence

The question has been whether non-executive directors actually act in shareholders' interests or whether they are more inclined to be sympathetic to the desires of their executive colleagues? The qualification of 'independent' becomes questionable when non-executive directors have personal ties with the CEO or other executive members. Definitions of independence have ranged from barring all business relationship between the director and the company to focusing on personal as well as business ties[53].

Generally speaking, any outside connection between them and the executives will hamper their effectiveness on the board. As Clark rightly points out, even non-executive directors may not be completely objective decision-makers due to their connection with the executive team which they are supposed to monitor.[54] The result is that the non-executives are not in a position to oversee the actions of the executive team. Emphasizing this position Elson identifies the management-dominated, passive board of directors as the most significant problem facing public companies today.[55]

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53. The National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on Directors' Professionalism (1996), appendix C at 37 gives the definitions of director's independence from various sources

54. Clark, J.J., Khan v. Lynch Communications Systems, Inc.: A Major Step Toward Clarifying the Role of Independent Committees, 1995, 20 Del. J. Corp. L 564, 581

55. Elson, C.M., Director Compensation and the Management-Captured Board - The History of the Symptom and a Cure, (1996), 50 SMU l. Rev. 127 at 127.

Where the selection of non-executive directors is being done by the chief executive they are bound to feel that they owe their tenure on the board to the executives which they are supposed to monitor. According to Davis and Kay:

> " Non-executives are, in general, picked by the executives, owe their salary to the executive, and commonly share social and business connections with the executives. ....It is hardly surprising that changes in executive management are more frequently the product of expensive, external action through take-over than consequences of the activities of non-executive directors."[56]

c) Membership Of Board Committees

Companies have sought to enhance non-executive directors' roles through their participation on board committees the most important of which are the nomination, remuneration and audit committees. Membership of such committees is meant to give non-executive directors greater scope to exercise their independent influence, protected from the risk of domination by the executive team. Involvement in board committees should, therefore, afford them the opportunity to oversee important policy decisions of the company

Although there is evidence that U.K. companies are now attaching importance to the creation of board committees, more companies have remuneration committees than they do nomination committees. A 1995 survey shows that almost 50% of the companies that responded did not have a nomination committee. When compared

56. Davis, E. and Kay, J. Corporate Governance, Takeovers and the Role of the Non--Executive Director, in Bishop, M. and Kay, J. (eds), European Merger Policy Ch. 5, p. 212 (Oxford University Press)

with the U.S. position, where it has been shown that 95% of potential boardroom candidates are recommended by a nominating committee, it becomes obvious that U. K. companies have a long way to go in this direction[57].

It is note-worthy, however, that even when non-executive directors are determined to fulfil their duties to shareholders they may not be given the detailed information about their firm's business, thus having no basis on which to challenge management decisions. Apart from that, non-executive directors normally hold only a nominal amount of shares in companies on whose board they serve.[58] Given how little non-executive director's financial well-being is tied to corporate performance these directors have little incentive to devote the amount of time and energy needed to effectively monitor corporate managers.

Despite the fact that the establishment of board committees offers more scope for non-executive directors to exercise their monitoring powers, this position does not resolve the conflict of interest that sometimes exists. Even when they are acting in their capacity as committee members, non-executive directors still form an integral part of the overall board, with the same rights and duties as their executive colleagues.

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57. Ibid at 194

58. Monks R. and Minow N, Corporate Governance (1995),199, Blackwell Publishers - where they note that all too often, outside directors hold, at best only small proportions of their net worth.

C) CORPORATE CONTROL UNDER GERMAN LAW

1. The Main Characteristics

The German system is the classic two-tier model consisting of the supervisory board (Aufsichrat), which has both shareholder and employee members, and the management board (Vorstand). The supervisory board's main functions are to appoint, dismiss and supervise the company's management and to report to the shareholders' meeting on management performance. In order to avoid conflict of interest and function, the supervisory board members may not also be members of the company's management board. Thus a significant aspect of the German system of corporate control is the supervisory board as the traditional body of control. This board deals with policy matters such as long term plans and important corporate transactions. Although German supervisory boards do not include any management members, co-determination law requires that they include employee members.[59]

One of the strengths of co-determination is that it enhances a better flow of information from the shop floor to the boardroom. This can lead to improved working conditions for the employees and better working relations. Corporate goals, in that system, are therefore defined more widely than shareholder profit with the interests of labour and other stakeholders receiving particular safeguards in management policy decisions. In this regard the German system differs from the Anglo-American system where there is little or no labour input in decision-making.

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59. Section 96 para 1 AktG 1965.

The German system of corporate control takes the long-term interests of their companies into consideration,[60] and companies are accountable to a wide range of interests than solely that of shareholders. This emphasis on long-term benefit is also reflected in greater investment in plants, equipment and research than occurs in the Anglo-American system. The result is that less emphasis is placed on returns to shareholders. Low dividend does not create a problem to major shareholders - the banks - as they have other business relationships with the companies in which they invest.[61]

This long-term relationship with stakeholders makes it difficult for companies to take quick decisions and changes, thus causing inflexibility and rigidity. When compared with U.K. and U.S. boards, the decision-making process and speed of response to issues by German boards may, therefore, be slower. On the other hand, the dual board system whereby the supervisory board appoints, oversees and dismisses management board members and yet does not participate in its decision-making processes, enables the decisions of management to be free from the influence of the supervisory board. On this Roe comments :

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60. The importance attached to the long-term welfare of German companies is reflected by the heavy investment in human resources which, according to Hampden-Turner and Trompenaars up to 70 per cent of all German employees are occupationally qualified, compared to 30 per cent in the U.K. Hampden-Turner,C. and Trompenaars,A., The Seven Cultures of Capitalism, 1994, 233-4, (London: Piatkus), .

61. Ibid at p. 226.

> " The supervisory board provides shareholders with influence, although not control, in corporate governance. Managers still have the upper hand, but the tilt is not nearly as pro-management as it has historically been in the United States."[62]

This more formalised German structure constitutes an advantage in that recognition is given to the difference in the position of executive and non-executive directors with the effect that non-executive directors are not legally required to participate in managing the affairs of the company.[63] In addition the supervisory board posseses the authority to compel reports on demand and can require management to obtain its approval before entering into certain transactions.[64] Despite the supervisory role of this, it must not interfere with the active management of the company's affairs, thus the supervisory board cannot give binding orders to the management board.[65] The function of management cannot, therefore, be assigned to the supervisory council, nor does approval of any transaction by the supervisory council preclude the management board's liability for damages.[66] The general meeting, on its part,

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62. Roe, M.J., Some Differences In Corporate Structure in Germany, Japan and the United States, 1993, 102 YALE L. J. 1 at 19.

63.The conflict in the functions of directors on a unitary board can be exacerbated where on person occupies the positions of Chief Executive Officer and Chairman of the board. The occupant of these positions would experience a conflict between his or her commitment to management and the need to give due regard to the interests of shareholders.

64. For example, a company's supervisory board may insist on the extension of credit above a certain level depending on receipt of prior approval. – Baums supra note 37 at p.510

65. Section 111 para 4 AktG 1965

66. Section 93 para 4 AktG 1965

cannot interfere with questions of business management and may only deliberate on and resolve matters if the management board so requests.[67] In practice, the management board may obtain prior consent of the shareholders when contemplating important contracts in order to protect themselves from liability.[68] Decisions in the supervisory council are taken by a simple majority vote unless the articles provide for higher majorities. Absent members may vote in writing[69] and written, telegraphic, or telephoned resolutions are permitted if no member prostests.[70]

Under German law although it is the management board that has sole responsibility for managing the company[71] it's functions depend on the type of company, and the number of its employees. Two of the main functions of the management board are the preparation of the annual accounts for submission to shareholders and decisions on the declaration and payment of dividend. Statute gives the power to all members jointly so that each transaction has to be approved by all the members of the management board and not just a majority of them.[72] The articles of

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67. Section 119 para2 AktG 1965

68. Section 93 para 5 Aktg 1965 .

69. Section 108 para 3 AktG 1965

70. Section 108 para 4 AktG 1965.

71. Section 76 para 1 AktG 1965.

72. Section 77 para 1 AktG 1965

a company or the rules of procedure for the executive board may, however, provide otherwise but may not provide that one or more members of the executive board can decide differences of opinion within the organ against a majority.

The relationship between the executive board and the supervisory council is governed by detailed legal provisions. The executive board has to supply the supervisory council with complete and correct information about the business of the company[73]. The supervisory council may, however, demand additional reports at any time from the executive board.[74] Under German law the issue of shareholder supremacy is less important since there is scope for external influence on the board by other factors. Although the chairman of the supervisory board, who comes from the shareholder side, always has a casting vote, in practice management is not answerable only to shareholders. This is because employee representatives and union leaders constitute half the directors on the supervisory board of German companies with more than 2000 employees, and one third in smaller companies.[75]

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73. Section 90 AktG 1965

74. If the demand for additional information is supported by another member of the supervisory council, the executive board is required to furnish the information - Section 90 para 3 AktG 1965. The reports of the executive board are open to inspection by every member of the supervisory council - Section 90 para 5.

75. Franks J. & Mayer C, Capital Markets And Corporate Control : A Study Of France , Germany And The U.K.(1990) 5 Econ Poly 191.

2. The Role Of German Banks In Corporate Control

An examination of internal control in German companies leads naturally to the role of banks in influencing management. The banks have played an important part in financing industrial development when compared with the market-based Anglo-American system. Since German public companies rely on banks and not the market as their primary source of external finance, banks participate actively in governing German companies as creditors and substantial holders of equity.[76] In addition the institutional structure of German financial system is also based on the principle of universal banking.[77] A universal bank is free to provide a wide range of services from commercial to investment banking, to investing in equities on its own account. This freedom is limited only by a few prudential rules which are not very effective thus giving banks wide latitude to own equity[78].

German banks' voting powers come not only from direct ownership of shares but, more importantly, from serving as custodians for individual shareholders. Banks act as brokers for their clients, and individual investors deposit their shares with banks

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76. See chapter three of this work on The Role Of Institutional Shareholders in Corporate Governance at p. 26

77. Eckstein W, The Role Of Banks In Corporate Concentration In West Germany, 1980, Zeitschrift Fur Die Gesamte Staatswissenschaft, 465 at 471

78. The most restrictive rule appears to be the requirement that total qualifying investments in equity and real estate should not exceed the banks capital. However, special banks such as savings banks and mortgage banks are often subject to different and more onerous legislative rules with regards to their equity holdings. - Deutsche Bundesbank, Banking Act of the Federal Republic of Germany, 1991, 31, Frankfurt.

which vote these custodial shares. Professor Baums has summarised the voting powers of German banks thus:

> " All banks together on average represented more than four - fifths of all votes which were present in company meetings. With one exception, they always had at least a majority (more than 50 %) of the votes present. Consequently, they were able to elect the members of the supervisory boards (so far as these are elected by the shareholders, not the employees). Changes to the articles and bylaws of the corporation could not be effected against their votes. In 22, or two - thirds, of the firms the banks voted more than three - fourths of the stock present, and thereby could change the articles and by–law."[79]

It is, therefore, difficult for German corporate managers to pursue damaging corporate strategies for extended periods without facing outside intervention from institutional shareholders. Reiterating this Roe asserts :

> " It is doubtful that German managers can even lawfully make a proxy solicitation. Instead German managers must filter proxy solicitation through bankers, who vote their own stock, their mutual funds stock, and their customers custodial stock ."[80]

Such limits placed on corporate managers ability to manipulate the voting processes appears to give German banks huge powers, but the extent to which these banks actually use their powers to influence corporate decision-making for the benefit of shareholders is difficult to assess. There is, therefore, no way of guaranteeing that bank powers will be exercised in the shareholder's interests and not used in protecting banks' positions as major creditors.

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79. Baums T, Should Banks Own Industrial Firms? Remarks From The German Perspective, (1992), Revue de la Banque de Belgique 5. at 507 .

80. Roe, M.J. Some Differences In Corporate Structure In Germany, Japan and the United States, (1993) 102 Yale L.J. 46

In the face of the growing internationalisation of capital markets and the increasing competition for capital the German 'Universal' banking system, which was generally seen as an attractive feature of the German corporate structure, is now being seen in a different light.[81]

The Oxford Analytica has put this changing view succinctly when it states:

> " structures and practices which have been established over the years to favour domestic management within the country over foreign and non-managerial interest are now being threatened by the need to attract the capital of major international investors."[82]

The number of industrial disasters involving big German banks seem unending - the massive financial losses by Metallgesellschft, controlled by Deutsche and Dresdner banks, the fraud scandal involving Deutsche bank supervised Balsham/ Procedo and the cash-flow crisis and emergency refinancing of Kloeckner-Humboldt- Deut, which is 38% owned by Deutsche bank, are but a few.[83] The realisation of the advantages of international competition is likely to bring about the introduction of the long demanded legislative changes. To this effect formerChancellor Helmut Kohl

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81. Fisher A, Survey - Germany 96: Two-Tier System Under Scrutiny, Fin. Times 21 Oct. 1996 p. 11

82. Oxford Analytica Ltd, Board Directors and Corporate Governance: Trends In The G7 Countries Over The Next Ten Years (Oxford, 1992), 81 at 142; Also Frank and Mayer, European Capital markets And Corporate Control, in Bishop and Kay (eds) European Mergers And Merger Policy (Oxford, 1993) p.163

83. Saunderson A, Power Point, The Banker, March (1995) p. 23

had stated:

> " the cumulation of influence by banks via industrial stakes, supervisory board mandate and voting proxies must, alongside their function as credit suppliers, be reviewed".[84]

D) CORPORATE GOVERNANCE IN THE UNITED STATES

Under the U.S. traditional corporate structure the board of directors manages the company's business and makes policy decisions, the officers act as agents of the board and execute its decisions, while the shareholders elect the board and decide on major corporate actions or fundamental changes. Under this model the officers are agents not of the shareholders but of the board, while the board itself is conceived of not strictly as an agent of the shareholders but as an independent organ of the company. The effect is that shareholders have no legal power to give binding instructions to the board on matters within the boards' powers.

In recent times, it has become increasingly clear that this traditional model has become inadequate as corporate boards rarely perform either the management or the policy-making functions. In large public companies policy-making, like management, has become an executive function. The ownership structure of a company and its relationship with management affects, to some extent, the way that a company is directed. To ensure good governance of companies, it has been

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84. The release of Chancellor Helmut Kohl's government in The Annual Economic Report, January 1995, 4.

proposed that active involvement of shareholders be encouraged.[85]

1. The Corporate Electorate

According to the traditional corporate structure, shareholders - the electorate - have a role in corporate control which they exercise at properly convened meetings. They appoint directors annually[86] and can also remove them before their terms expires for cause or without cause depending on the provision of the regulating statute[87] and have power to alter the bylaws[88]. At such meetings they have the right to increase or decrease the share capital, approve voluntary dissolution,[89] and authorise other fundamental changes in the company. Like in the U.K. it is viewed that the appointment of non-executive directors, who are not affiliated to the company, should enable shareholders to rely on this group to protect their interests. To this effect para 3A.01 of the American Law Institute's Principles of Corporate

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85. Bain N. and Band D. Winning Ways Through Corporate Governance, (1996) p. 17, Macmillan Books.

86. Section. 8.03 (d) revised Model Business Corp. Act 1984

87. Section 8.08 Revised Model Business Corp. Act 1984

88. For the difference between articles, by-laws and charters see Cox J.D., Thomas L.H., and O'Neal F.H., Corporations, 1995, Sections 3.11 - 3.12, Little, Brown & Co.

89. Section 14.02 RMBCA

Governance recommends that:

> The board of every large publicly held corporation should have a majority of directors who are free of any significant relationship with the corporation's senior executives, unless a majority of the corporation's voting securities are owned by a single person, a family group, or a control group"[90]

Important though these powers are, the situation with individual shareholders is still as Berle and Means described it.[91]

Even if individual shareholders have the knowledge and motivation they would be faced with the "free rider problem"[92] and for the active it would turn out a costly venture. One of the ways that they can overcome this problem is by acting in concert with others. Even when shareholders are willing to bear the cost of intervention, certain restrictions come into play. They cannot interfere with directors' powers to carry on the ordinary business of the company. These include binding the company contractually, selecting and removing officers (even for cause), fixing executive compensation, setting dividend policies and deciding on marketing or production policies. In addition shareholders cannot compel or change particular decisions of the board unless the board has failed to comply with the corporate

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90. The American Law Institute's (ALI's) Principles of Corporate Governance, 1994; The American Business Roundtable Statement also endorses a board structure based on the majority of outside directors. - Business Roundtable's Corporate Governance And American Competitiveness, p249

91. Berle, A. and Means, G. supra note 6, at p. 65

92. Some shareholders rest in the knowledge that other shareholders will make the efforts needed to bring about management changes or to rectify problems which will serve to benefit all shareholders. Such shareholders see no reason to incur a private cost for public gain so they simply take a free ride on the efforts of the active shareholders.

statute or constitutive document, or the directors are in beach of their fiduciary duties. Shareholders can, however, still exercise a monitoring role by compelling information from the company or by challenging board actions.[93] There is also the requirement that a company should provide shareholders with annual financial information, including profit and loss accounts, and the end of year balance sheet. In addition, the right to inspect the company's shareholders' list is an indispensable tool for proxy voting. The statutes[94] are, however, often ambiguous about what shareholder information should be furnished when a list is requested. Some simply specify a "shareholder list" without describing its content.[95]

As contributors of corporate capital, shareholders are entitled to employ watchmen to guard their enterprise and to this effect they may appoint a committee to investigate the affairs of the company, and may require management to give an account or a report of the proceedings at the annual meeting.[96] If the charter vests the power to manage the affairs of the company in a board of directors, it is not within the power of the shareholders under company bylaws or otherwise, to vest management in an executive committee or to appoint an agent to act or function with

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93. Section 16.20 revised Model Business Corp. Act 1984

94. For an example see section. 219 (a) Del. Gen. Corp. Law 1991.

95. Delaware courts only require management to provide those lists to existing shareholders and not potential ones. - Hatleigh Corp. v. Lane Bryant; Inc., 428 A. 2d 350 (Del. Ch. 1981)

96. Securities & Exchange Comm. v Trans-American Corp. 163 f2d 511,332 US 847

the directors.[97] The separation of ownership and control might result in power being concentrated in private hands with the creation of top-level corporate managers who have far too much power over corporate decision-making. To prevent this situation it is thought that shareholder democracy should be encouraged to ensure that corporate power comes from a broad base of owners.[98]

Many reformers have viewed shareholder democracy with scepticism by looking at shareholders as being interested only in profit maximisation and being far more concerned with their own good than the overall good of the company. It is, thought that shareholders are too narrowly focused on their own self-interest and corporate managers should make it their duty to balance shareholders interest with those of the company and the public at large.[99] Both the 1969 Model Business Corporation Act and the 1984 Revised Model Business Corporation Act provide that the business of the company is to be managed by a board of directors, and a majority of state company codes have similar or identical provisions.[100] In the absence of

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97. Charlestown Boot & Shoe Co. v Dunsmore , 60 NH 85

98. Blair, M. M., Ownership And Control: Rethinking Corporate Governance For The Twenty First Century, (1995), 75-76, The Brooking Institution – where she stated that various ways have been explored to encourage shareholder participation, increase their influence and strengthen the mechanisms of shareholders' voting for purposes of keeping the exercise of management powers under constant check.

99. Bamonte, The Meaning Of " Corporate Constituency " Provision Of The Illinois Business Corporation Act, 1995, 27 Loyola U C L J I; Committee on Corporate Laws, Section of Business Law of the American Bar Association, Other Constituency Statutes : Potential For Confusion , 1990, 45 Bus. Law 2253.

100. Section 300 Cal. Corp. Code 1992; Section 141 Del. Code Ann Law tit. 8, 1990; Section 701 NY Bus. Corp. Act, 1989.

statutory authority the powers of management vested in the directors must be exercised by them and not by shareholders.[101]

To this effect it has been held that a shareholders' agreement that violates a statute by attempting to usurp directors managerial responsibilities is invalid. In a New York decision, the highest court of that state held invalid an agreement by the shareholders that gave the holders of 50 % of the company's shares broad powers in the management of the company's theatres.[102] In Charlestown Boot & Shoe Co. v. Dunsmore,[103] the plaintiff company in general meeting voted to set up a committee to act with the directors in winding up its affairs. The directors refused to act with the committee and continued to run the company's business. The court held the general meeting's action to be a violation of statute. According to the court:

> " Statute does not authorise a corporation to join another officer with the directors nor compel the directors to act with one who is not a director..... When a statute provides that powers granted to a corporation shall be exercised by any set of officers or agents such powers can be exercised only by such officers or agents , although they are required to be chosen by the whole corporation ..... "[104]

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101. The Delaware case of Securities & Exchange Commission V. Transamerica Corp. 67 F Supp. 326 or 163 2F d 511

102. Long Park v. Trenton - New Brunswick Theatres Co., 297 NY 174, 77 NE 2d 633, see also the case of Clark v. Dodge, 269 NY 410, 199 NE 641

103. 60 N.H. 85 (1880)

104. Ibid at 108

There has also been growing public concern over the ability of the law to regulate managerial power for the purpose of protecting the interest of corporate stakeholders. In the heat of that concern the American Law Institute (ALI) authorised the commencement of the Corporate Governance Project (CG Project) in 1978.[105] The launching of the CG Project by the ALI was clearly a move towards the setting up of standards for the internal operations of corporate systems to enhance monitoring and accountability.[106] The CG Project advocates what might be called a 'board monitoring scheme' for the oversight of managers of "publicly held corporations" (PHCs).[107] The project envisages a division of functions between the senior executives of the company, in charge of the day-to-day management, and the company's board of directors whose task is to monitor and control the executives.

The CG Project also puts forward a number of other recommendations designed to enhance the monitoring power of the board. It recognises that if the board is to act as an effective overseer, its composition must be wrested from management. It

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105. The outline for a 'Project On The Structure and Governance of Corporations' 13th May 1978, is filed as Appendix 1 to the Minutes of the 164th meeting of the ALI council, 16th May 1978; Selimen has also dealt elaborately on the background to this project - Selimen, A Sheep In Wolf's Clothing: The American Law Institute's Principles of Corporate Governance Project (1987) 55 Geo. Wash. L. Rev. 325

106. Eisenberg, An Introduction To The American Law Institute's Corporate Governance Project, (1984) 52 Geo Wash. L. Rev. 495

107. A publicly held corporation (PHC) is defined in S.1.31 of the CG Project as a corporation with 500 or more record holders of equity securities and at least $5m of assets.

seeks to achieve this through its insistence on 'independent outside directors' and its recommendation of the establishment of committees of the board. Section 3.05 requires the adoption of audit committees by large public companies while Section 3A.05 recommends the adoption of a compensation committee to advise on directors' and senior executives' remuneration.

2. Independent Outside Directors

An outside director does not automatically equate with an independent director since that director may still have business relationships with the company which might influence the director's judgment. Outside directors are essentially part-time participants in their companies due to the fact that they hold other important and demanding jobs thus subject to severe time constraints. Apart from the issue of time constraint there is often informational imbalance between the outside and inside directors[108]. The result is that U.S. corporate boards tend to be dominated by the chief executives.[109] The role of independent, outside directors is said to be critical in the concept of corporate control. According to Chancellor William Allen of the Delaware Court of Chancery:

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108. Cox, Hazen and O'Neal, Corporations, (1995), at 9.4, Little Brown & Co. – where they state that outside directors have difficulties in playing an active role on company boards because of time constraints and lack of adequate information.

109. Lorsch J. and MacIver E, Pawns or Potentates: The Reality Of American Corporate Boards (1989) at 84-89

> " Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of the long-term strategic, financial and organizational goals......Promotion of the long-term, wealth producing capacity of the enterprise ensures the benefit of the shareholders as the main risk bearers of the firm"[110]

In recent years there has been a concern in the U.S. for a new improved role for outside directors.[111] There is evidence to show that this is yielding good results. A 1991 survey found that the typical board of a U.S. public company had an average of three 'inside' and nine 'outside' directors.[112] The main question is whether outside directors actually act in shareholders' interests or whether they are simply endorsing the policy decisions of the executive. On this Harold Geneen comments:

> " nominally, outside directors are elected by the stockholders; actually, in most instances they serve at the pleasure of the chief executive.......It is well known and accepted that only those men and women who can get along with the chief executive' are elected to the board and stay on it. One might also ask how independent board members can be if they accept all the perks heaped on them by the management they are to judge. "[113]

Reiterating this point Prokesch notes that;

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110. Chancellor W.T. Allen, address at the Ray Garner (Jr) Corporate and Securities Law Institute, Northwestern University (30th April 1992), at p. 3

111. Johnson, An Insider's Call For Outside Direction, Harv. Bus Rev. Mar- Apr 1990 at 46; Rosenstein S. and Wyatt J, Outside Directors, Board Independence, and Shareholder Wealth, 26 J. FIN. ECON. 175 (1990); Weisbach M.S, Outside Directors And CEO Turnover, 20 J. FIN. ECON. 431(1988)

112. Korn/ Ferry, Board of Directors, 1991, 15

113. Gereen S.H, Why Directors Can't Protect The Shareholders, FORTUNE, 17th Sept. 1984 at 28

> " nominating committees that are supposed to choose impartial outside directors act as the arm and will of the chief executive, who feeds the names."[114]

A board of directors can only act at meetings which last for just a few hours. By reason of the time constraint alone, the typical board could not possibly manage the business of a large public company in the strict sense of the term. This same constraint precludes the board from making business policy decisions since policies cannot be formulated and developed by persons who put in a few working hours a month. Secondly if a typical board consists of directors who are economically tied to the executives, and are dependent on the chief executive's good will, outside directors are unlikely to dissent at a board meeting from the policies formulated by management. Shareholders' hope may be in the fact that different committees may be appointed to investigate the affairs of the company, recommend the level of remuneration for executive directors and appoint independent auditors to review the affairs of the company.[115]

3. Committees Of The Board

Statutes allow the board to delegate many of its functions to committees composed

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114. Prokesch S., America's Imperial Chief Executive, N.Y. Times 12th Oct. 1986 at 25

115. In Securities & Exchange Commission v Transamerica Corp., 163 2d 511, 332 US 847 – the court clearly stated the position in which shareholders find themselves.

of some of the directors.[116] The functions or powers that cannot be delegated to committees are normally specified, such as authorising the distribution of dividend, share repurchases, issuance of shares, amendment of the bylaws and other fundamental corporate changes [117] Committees of the board have, in recent years, assumed growing importance in the U. S. especially in public companies.[118] Board committees act on matters that come up between regular board meetings and often deal with open questions before presentation to the board. Normally the full board simply adopts or ratifies the committees' actions.[119]

These committees often consist of outside directors in order to provide an element of independence in matters where there are potential conflicts between the interests of management and those of shareholders. A recent development has been the use of specially appointed temporary committees to deal with particular transactions in which conflict of interests are likely to arise. An example is the special litigation committee (SLC) which decides on the company's position regarding shareholders derivative actions against management.

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116. Section 8. 25 Revised. Model Bus. Corp. Act 1984 .

117. Section 8. 25 (e) Revised Model Bus. Corp. Act 1984 .

118. Baysinger R. and Haskisson , R. E., The Composition Of Boards Of Directors And Strategic Control : Effects On Corporate Strategy, 1990, Vol. 15, Academy Of Management Review, 72 at 84.

119. Charkham states, with regard to board committees, that although all U.S. boards have at least one committee the list of committees is quite long, including finance, public policy planning, human resources. - Charkham, J., Keeping Good Company, 1995, 191, Oxford University Press

The SLC was in common use during the 1980s when company boards responded to a spate of derivative lawsuits by which shareholders challenged illegal activities by corporate officers.[120] Normally the board would appoint a committee, giving it full power to make decisions in the specific area on behalf of the company. Such a committee would usually comprise of directors who had not participated in the challenged transaction and hence could not be named as defendants. One is tempted to question whether members of a special litigation committee can be viewed as independent since they would be subject to pressure to dismiss charges against fellow directors. In Lewis v. Faqua[121] the court held that a committee member was not independent since he was a director when the challenged actions took place, was named as a defendant, had political and financial dealings with the company's Chief Executive Officer, and was the president of a university that had received significant contributions from the Chief Executive Director and the company.

E) CONCLUSION

In the three systems under review ultimate control, at least in theory, is in the shareholders. The trend in the Anglo-American system simply illustrates the problems caused by the separation of ownership from control. Although

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120. Solomon, L.D. and Palmiter, A.R., Corporations, (2nd ed) 1994, 506 (Little Brown & Co.)

121. 502 A. 2d 962, Del. Ch., 1985

shareholders still own their share certificates which is evidence of their property right, this piece of paper no longer accords them the rights which were traditionally associated with ownership. Within the existing control structure shareholders are given the right to appoint members of the board of directors and remove those that they are dissatisfied with. They should, be able to rely on the board to manage the company in a way that promotes their interests. In practice, however, shareholders are not well-protected in any way.

Although the usual language is that a company shall be managed by the board of directors, the reality is that the board usually appoints one or more full-time directors to serve as executive directors, with the chief executive officer as the head of the executive team. In modern corporate practice it is the chief executive officer rather than the board, who runs the company. In both systems a distinction has been made between management and the board of directors. The board in turn supervises and makes general policy decisions with the emphasis being placed on independent non-executive directors who are supposed to monitor the executive team.

Under the German two-tier system the supervisory board is the body that monitors and controls the management board. Two of the most significant functions of the supervisory board are the appointment and removal of the management board members. Though Anglo-American company law does not establish a special supervisory body, practice has often created a similar organ. The functions of non-executive directors is comparable to those of the German supervisory board, though it has to be remembered that under U.K and U.S. laws every board member has the obligation of managing the company and safeguarding their investor's interests.

Although the supervisory board is generally excluded from management, it quite often fulfils management function since its meetings set the pattern of the general corporate policy. On this basis members of the management board are normally permitted to participate in supervisory board meetings although they do not vote. [122] This situation shows that it can prove difficult to preserve a clear division between management and supervision. Just like the monitoring role of non-executive directors have been questioned so have there been doubts whether members of the supervisory board are really competent to control the executive board effectively.

There is no doubt that in most situations the executive board has a more detailed knowledge of the company and its prospects. Although this is partly due to the fact that the supervisory board only meets infrequently[123] it has to be emphasized that, like non-executive/outside directors of the Anglo-American system, the members come from many different backgrounds, professions and perspectives. The draw-back in the unitary board system is that with the role of the non-executive as 'watchdogs' a possible danger is that they may ignore the shared legal responsibility that corporate board members are supposed to have. This might set one category of directors against another and could lead to a weakening of the notion that a board should be a homogeneous group with shared responsibilities.

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122. Section. 109, para 1 AktG 1965

123. Section 110 para. 3 AktG 1965 provides that the supervisory board shall, as a rule, be convened once every calendar quarter.

CHAPTER THREE

THE ROLE OF INSTITUTIONAL SHAREHOLDERS IN CORPORATE CONTROL

A) INTRODUCTION

Although shares in small private companies are usually owned, directly or indirectly, by individuals involved in the management of a company, in public companies shareholding is generally concentrated in the hands of institutions. Institutional investors are organisations which raise funds from individuals and companies with the intention to re-invest as principals. This category of investors includes insurance companies, private pension funds, public pension funds, investment trust companies, unit trusts, industrial and commercial companies, banks and building societies.

Institutional investors therefore constitute a diverse group with pools of money invested for different purposes and with different obligations, owing the duty to manage funds and assets on behalf of other people. Stating this duty to produce good returns to fund owners Bain and Band have asserted that:

> " the policy of institutional investors is generally to invest in companies or sectors which they see as offering sustained above-market average growth, in terms of total return."[1]

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1. Bain, N. and Band, D., Winning Ways Through Corporate Governance, 1996, 95, Macmillan Press Ltd.

For institutional shareholders in any system to exert any level of influence over the composition of their board of directors a reasonable proportion of shares must be held by them.[2] Apart from the shareholding structure, the effort, time and financial cost involved in monitoring corporate management can only be beneficial if many institutions are involved in such moves. Despite their growth over the past three decades the question remains whether there will be active participation by this group to make shareholder control over management a reality.[3]

As already noted[4] it can be difficult to organise individual shareholders to play an effective monitoring role and determine the composition of their boards. Although institutional shareholders share a common interest with individual shareholders - which is that their company should be well run and profitable - institutions are in a position to ensure good corporate standards through the use of their large shareholding.

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2. Benfield has emphasized that institutional investors have begun to bridge the gap created by the separation of ownership from control in large companies. - Benfield, R.E., Curing American Management Myopia: Can The German System of Corporate Governance Help?, 1995, 17 Loy.L.A. Int'l & Comp. L. J. 615 at 617; Also Gordon, J.N., Institutions As Relational Investors: A New Look At Cumulative Voting, 94 Colum. L. Rev. 124, 130

3. Brancato C.K, The Pivotal Role of Institutional Investors In Capital Markets, in Institutional Investors : Passive Fiduciaries To Active Owners, Corp. Law and Practice Handbook Series No. 704, 1990, 406

4. See chapter one of this work at p.11

This chapter analyses the influence of institutional investors on corporate management and their ability to promote the exercise of shareholders' powers to appoint and remove directors in the United Kingdom, United States and Germany. It examines the prospect of the increasing number of institutional holdings leading to a change in the attitude of shareholders as a whole. Attempts will be made at answering the question whether the present efforts by institutional shareholders at determining the composition of their boards is seen as adequate for purposes of controlling the companies in which they invest. It will consider the question whether institutional investors are in a position to play a more active part by channelling their efforts towards controlling their managers instead of voting with their feet whenever they are dissatisfied with management.

B) INSTITUTIONAL SHAREHOLDERS IN THE UNITED KINGDOM

The era of take-overs in the United Kingdom led to a revival of the corporate governance debate and in the heat of that debate attempts were made at persuading institutional shareholders of the importance of their monitoring role over corporate management. Institutions have been encouraged to discipline inefficient management instead of simply relying on market forces.[5] They have various courses of action, one of which is the exercise of their

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5. Marsh P.R, Short-Termism On Trial, (1990), Report Commissioned by the Institutional Fund Managers' Association, 35; Also Robinson A., Shareholder Power : Time For Institutions To Flex Muscles, The Guardian, 30 June 1995, 23

voting rights at general meetings. Institutions have been urged to make positive use of their voting rights by registering their votes whenever possible. Emphasising the importance of the exercise of institutional voting rights the Cadbury Report states:

> "Voting rights can be regarded as an asset, and the use or otherwise of those rights by institutional shareholders is a subject of legitimate interest to those on whose behalf they invest."[6]

Available emperical evidence on the level of institutional (fund manager) voting has shown that voting levels are low. According to surveys undertaken by the National Association of Pension Funds the voting policies of investment managers of pension schemes that responded to its surveys in 1990 to 1994 were as indicated in Table A below.

Table A - National Association of Pension Funds: Survey of Voting Policy (%)

	1990	1991	1992	1993	1994
Voting at all times if practicable	20	21	26	26	28
Voting only on contentious issues	33	34	34	31	32
No Votes	23	24	22	24	21
Others(with no policy)	24	21	18	19	19

Source: National Association of Pension Funds (NAPF) (1990-4), Annual Survey of Occupational Pension Schemes (London: National Association of Pension Funds)

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6. Para. 6.12, The Report on the Financial Aspects of Corporate Governance, Dec. 1992, (Cadbury Report) Gee and Lee Ltd.

1. The Attitude Of U.K. Institutions

U. K. institutions have been passive owners and whenever anything goes wrong in their companies they would rather sell their shares than intervene.[7] Institutional shareholders in the U. K. are said to be only interested in short-term gains which the capital market reflects. An important aspect which is often ignored is the pressure put on some institutions like fund managers to maximise performance. Institutions are then criticised for capitalising on large price rises resulting from take-over bids by selling their stakes knowing that if the bid fails share prices will fall. As Charkham rightly puts it:

> " All company managers want their own shareholders to belong to type A school. If they put pressure on their pension fund managers for short term results they push them towards type B.[8]

2. Recent Attempts At Monitoring By U.K. Institutions

In recent times institutional investors have become more actively involved in

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7. Confederation of British Industry, Investing for Britain's Future : Report of the CBI City and Industry Task Force, 1987, London, 18; see also Holberton S, Institutional Investors As Interventionists, Financial Times, 10 August 1990, p. 10 - where he stated that a familiar criticism made against institutional investors is that they are capricious owners who are too willing to take the short-term profit rather than stay with the company for the long-term gain.

8. Charkham, J.P., A Larger Role for Institutional Investors, in Dimsdale N. and Prevezer M. (eds), Capital Market and Corporate Governance, 1994, 103, Oxford: Clarendon Press; Also Blake, D., Issues In Pension Funding, 1992, 86, London: Routledge

the issue of corporate control in general and board composition in particular[9]. The strategies used by U.K. institutions include active dialogue with corporate managers and intervention where their company's business is not properly managed. This technique has been clearly stated in the report of M & G Group thus :

> "We believe strongly that, as an institutional investor, we should have constructive dialogues with management of companies in which we have a significant interest ..... We do not attempt to tell management how to run their businesses, but if a company's action seems likely to jeopardise the interests of shareholders, we find that constructive intervention can often be preferable to disposing of our holding."[10]

Along these same lines there have been a number of instances when publicised pressure of institutional holders has prompted a change in a company's board structure. This has been effected through institutional insistence on the dual position of chief executive officer and chairman of the board being split[11] and the appointment of truely independent non-executive directors to safeguard shareholders' interests. In 1991 efforts by a coalition of institutional investors led by Norwich Union, one of U. K's largest insurance

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9. Lewis W., Voting Record of Big Shareholders Improve, Financial Times 10th February, 1995, 8; See also Barnett A, Institutions Demand More Rights At A.G.M.'s, The Observer, 30th June 1996, 3

10. M & G Group plc, Annual Report And Accounts, 1992, 3; Also Lewis W., Institutions Press For All Directors To Face Re-Election, Financial Times, 25th September 1996, 1

11. Brown J.M, Smurfit Ready To Appoint New Chief Executive, Financial Times, 12 March 1996, 27

companies resulted in the replacement of the board of Tace plc.[12] This incident received widespread press attention mainly because the whole board was removed.

In 1993 there was a campaign led by Prudential to install a new management for Spring Ram. The company had falsified its accounts and, when it was discovered, Prudential and other institutions urged Spring Ram to find a new chief executive officer. In the end a new chairman chosen by Prudential was installed together with some other new directors.[13] In 1996, Sir Rocco Forte bowed to pressure from institutional shareholders to split his roles as chief executive and chairman of Forte, the hotel group. Institutions had lobbied for the roles to be split in line with the recommendations in the Cadbury report on corporate governance.[14]

In 1997 an influential institutional shareholder made a strong call for companies to appoint independent non-executive directors for the protection of shareholders' investments. A representative of Hermes, which controls £30 billion of British Telecom and Post Office Pension Funds, insisted that companies should take steps to ensure that non-executive directors are

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12. Gourlay R., Institutions Launch Bid To Oust Tace Board, Financial Times, 4 May 1991,10; Cohen N, Getting Directors On Board, Financial Times, 6 April 1992, 12

13. Bolger A, Rooney's Future Remains Unclear, Financial Times, 15 July 1993, 22

14. Daneshkhu S. and Blackwell D, Forte Chief Agrees To Divide Role, Financial Times, 16 January 1996, 21

independent of management. It stated that in its view too many non-executives are being appointed "on the basis that they are related to the boss, ... or because they were 'old cronies' of the chairman."[15]

Opposition to the creation of equity shares which carry non-voting rights appeared as the third point on the 1991 Institutional Shareholders' Committee Code of Practice.[16] In 1992 the Institutional Fund Managers' Association carried the same message both to United Kingdom and continental stock exchanges.[17] Another area of intervention by U. K. institutional investors has been in connection with pre-emption rights of shareholders. Institutions have insisted on more restrictive rules than statute imposes, for instance where statute allows shareholders to disapply the pre-emption requirement for up to five years at a time the Stock Exchange's Rules, under institutional shareholders' influence, have placed some limits to that period.[18]

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15. Finch J, Boardroom 'Old Boys' Under Fire, The Guardian, 20 September 1997, 20.

16. ISC, The Responsibilities Of Institutional Shareholders In The United Kingdom 1991, 5, London

17. Investors Seek More European Rights, Financial Times, 15 July 1992 18.

18. Pre-emption Rights, 1987, 27 Bank of England Bulletin, 545; Council of the Stock Exchange, Admission Of Securities of Listing, Section 5, Chapter 2, para. 37.1. This provision is buttressed by the requirement of Section 3, Chapter 2, Part 3, para. 3.5 that when an issue is proposed and 10% or more of the voting capital of the company is likely to remain unissued, directors must undertake in the listing particulars to make no further issues of shares within the following year, except on a pre-emptive basis, unless the shareholders in general meeting approve of the specific issue.

Institutional shareholders in the U.K. have also shown their concern over the potential conflicts of interest involved in the setting of executive compensation. They have insisted on detailed information being given to shareholders on how directors' pay are determined by remuneration committees.[19] Institutional investors have also emphasized that executive share option schemes should only be used where there has been a genuine improvement in the performance of management.[20]

These attempts by institutional shareholders show that intervention by institutions definitely occurs. The difficulty lies in making an accurate estimation of the scale of activism by this category of investors. Although changes to the composition of corporate boards are recorded,[21] the type of pressure that produces the changes, which can be applied behind closed doors rather than in general meetings, is sometimes unknown.[22] Another form of intervention has involved informal collaboration between institutions for

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19. Lewis W, Institutions Call For Detail On Top Pay, Financial Times, 29 March 1995, 7

20. The guidelines produced by the National Association of Pension Funds, entitled Share Schemes - A Consultative Approach, 1992, London; Lewis W. Shareholders Flex A Muscle On Top Pay : A look At The Options As Whitehall Ponders Ways Of Restraining Directors' Salaries, Financial Times, 7 December 1994, 8

21. Barrie C, British Telecom Engineers Reshuffle In Boardroom, The Guardian, 25 November 1995, 38; Daneshkhu S. and Blackwell D., Forte Chief Agrees To Divide Role, Financial Times, 16 January 1996, 21

22. House of Commons, Session 1990-91, Trade and Industry Committee Minutes of Evidence, 8 May 1991, HC 226-X, para. 928ff, (question to Mr Sandland, Chief Investment Manager, Norwich Union Fund Manager Ltd)

purposes of exerting pressure on boards to persuade them to make policy changes or change the managers. Most such informal intervention is exercised privately in order to avoid damaging the relationship with a company's management.[23] The most prominent move by British institutions at collaborating together for purposes of monitoring corporate activities has been the formation of the Institutional Shareholders' Committee (ISC).

3. The Institutional Shareholders' Committee (ISC)

This committee was set up in response to the changing pattern of share ownership in the United Kingdom and, while originally formed in 1973, stopped functioning by the late 1970s.[24] It was revived in the 1980s with its main goal being the formulation of general policies. This committee constitutes of five associations :

The Association of British Insurers (ABI)

The Association of Unit Trusts And Investment Funds (AUTIF)

The Association of Investment Trust Companies (AITC)

The Asset Management Committee of the British Merchant Bankers' Association (BMBA)

The National Association of Pension Funds (NAPF)

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23. Snoody R., Emap Assures On Non-executives, Financial Times 13 July 1996, 8; Lewis W, Institutions Press For All Directors To Face Re-Election, Financial Times, 25 September 1996, 1.

24. Dobbins R. and McRae T., Institutional Shareholders And Corporate Management, 1978, 5-6.

Being an association of associations, the Institutional Shareholders' Committee (ISC) acts as a medium through which major shareholders can express their views[25] and looks after its members' interests. One of the purposes of the ISC is the provision of a forum for member associations to meet and discuss common problems. Every six months or so the committee circulates a discussion paper asking the associations involved for comments.[26]

Even though the responses to these papers vary according to the particular viewpoint of each association, the opportunity to discuss them at ISC meeting enables this category of shareholders to express their views. Discussions at such meetings have focused on shareholders' duty to vote at companies' annual meetings to ensure that they have a say in the composition of their boards in order to maintain their investment value.[27]

It is therefore clear that there have been various instances when institutional shareholders' actions have brought about fundamental changes in their companies as a result of collaborations with other associations and

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25. An example is institutional opposition of the favourable terms on which housing was made available to Marks and Spencers' directors - Schuller, Age, Capital and Democracy, 1986, 99; Lewis W, Institutions Call For Details On Top Pay, Financial Times, 29 March 1995, 7.

26. Corporate Governance And The Market For Corporate Control Of Companies : Aspects Of The Shareholders' Role, Economic Division, Nov. 1989, Bank of England, Discussion Paper No. 44

27. Lewis W, Pension Funds Told Of Duty To Vote : Plan To Ensure Institutional Shareholders Are Responsible Investors, Financial Times, 15 November 1995, 22.

institutions under the umbrella of the ISC.[28] Commending the work of this committee Charkham states that it 'gives a steer in the right direction.'[29]

4. The Growth of Institutional Shareholding

Statistics show that the growth of institutional shareholding in the United Kingdom has exceeded those of the other jurisdictions under study. In 1969, 34.2 per cent of listed U. K. equities were held by this category of investors and it was estimated that 42.9 per cent of the ordinary shares of listed U. K. companies were held by institutions in 1975. By 1985 that figure had increased to 59 per cent.[30] In 1990 an estimate of 60 per cent was given as the percentage held by institutional shareholders,[31] and that figure increased to 60.4 per cent by 1992.[32] With these increases in their shareholding institutions should have sufficient incentives to monitor and control the functioning and management of their companies. The high stakes that institutions hold in their portfolio companies should justify the cost of

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28. Barnett A, Institutions Demand More Rights At AGM's, The Observer, 30 June 1996, 3; Cohen N, Lewis W. and Sharpe A, Institutional Concern Over Possible Dividend Cut, Financial Times, 7 February 1996, 22

29. Charkham J, Keeping Good Company, 1995, 287, Oxford University Press

30. Cosh, Hughes, Lee and Singh, Institutional Investment, Mergers And The Market For Corporate Control, 1989, I Int. J. Indus. Org. 73, 77

31. See Pensions Investment Research Consultants Limited, Intelligence, July 1990, 11

32. Central Statistical Office, Share Register And Survey Report end 1992, London 1994, 8, London.

intervention even if this allows individual shareholders to take a free ride on institutional efforts.

5. The Need For Greater Activism

This increasing concentration of shares in the hands of institutional investors has brought about proposals to encourage institutional activism to ensure that their company management is more accountable to them. The rationale for these proposals is that the emergence of institutional investors as major shareholders in U. K. companies should provide the basis for enforcing the support for strengthening shareholders' rights.[33] In this regard the Cadbury Committee called on institutional investors to play a more active role in securing better corporate governance and to take positive interests in the composition of their boards.

The committee saw the development of constructive relationships between companies and their owners as central to this role of institutions. It emphasised:

> "Because of the importance of their collective stake, we look to the institutions in particular, ... to use their influence as owners to ensure that companies in which they have invested comply with the Code ...."[34]

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33. Riley B, Big Investors Urged To Be Active, Financial Times, 25 February 1994, 11; Robinson A, Shareholder Power : Time For Institutions To Flex Muscles, The Guardian, 30 June 1995, 23

34. The Cadbury Report supra note 6 para 6.16;

Activism by institutional shareholders can make individual investors with less voting powers rest in the knowledge that their interests are well protected. This will only happen if institutions are willing to bear the cost for the general good of shareholders. A survey published in 1987 found that voting by fund managers, as a matter of course, is uncommon[35] in spite of institutional insistence that companies should not issue non-voting shares. Although the value of votes lies in the threat of their use rather than their actual use, it would aid the role of institutions as interventionists[36] if they were obliged to express a view on all matters put to vote at general meetings. This important issue has been addressed by the ISC Code[37] and has been endorsed by the Cadbury Report[38]

Although there has been some degree of activism on the part of institutions, the main question is what the chances of extensive institutional intervention in the management of large U. K. companies coming about without the force of regulation are? Given the problems which dissatisfied institutions face in organising effective collective action, it is unlikely that mere exhortation will encourage institutions to be more active in their portfolio companies.

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35. Management Of United Kingdom Equity Portfolios, 1987, 27 Bank of England Quarterly Bulletin, 253, 257

36. Holberton S, Institutional Investors As Interventionists, Financial Times, 10 August 1990, 10

37. ISC, The Responsibilities Of Institutional Shareholders In The United Kingdom, 1991, 6

38. The Cadbury Report supra note 6, 50-51

C) INSTITUTIONAL SHAREHOLDERS IN THE UNITED STATES

Institutional investors in the United States are generally grouped into five categories: foundations and endowments, bank (non-pension) trusts, insurance companies, investment companies and pension funds.[39] The 1990's have witnessed dramatic increases in institutional share ownership in United States companies. In 1990, institutional investors owned 45% of corporate equity.[40] By 1993 that figure had increased to 54%.[41]

In the light of these developments it is tempting to think that these increases in the shareholdings of institutions will bring an end to the indifferent attitude of shareholders. It is expected that this increased ownership concentration in the hands of institutions should bring about improved activism by this category of investors? Commenting on this position Pozen states :

> "Because institutional investors now own a majority of the voting stock of publicly traded companies in the United States, they have an influence on the way these companies are run. Given their influence, institutional investors are under increasing pressure to become activist shareholders ....."[42]

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39. Institutional Investor Project, Columbia University, School of Law, The Growth Of Institutional Investors In United States Capital Market, 1988, 6

40. Koppes R.H. and K.J. Gillan, The Shareholder Advisory Committee, Directors and Boards, Spring 1991, 29

41. Cordtz D, Corporate Hangmen, Financial World, 30 March 1993, 24 at 25

42. Pozen R.C, Institutional Investors : The Reluctant Activists, Jan-Feb 1994, Harv. Bus. Rev. 140

Indicating its expectation of this group of shareholders the American Security Exchange Commission emphasizes :

> "Institutions, in becoming major shareholders, acquire the ability to play a pivotal role in monitoring the stewardship of their portfolio companies. They often possess the special expertise needed to effectively express shareholder concerns to the company and have the motivation to employ all available resources, including the right of shareownership, in order to maximize the economic performance of their portfolios."[43]

1. Evidence Of Activism

The appearance of institutional shareholders in the corporate arena gives the hope that they may be in a position to play an important role in the supervision of corporate management. There is evidence to show that owning large illiquid blocks of shares, for which there is only a limited secondary market, has prompted United States institutional investors to monitor their investments more diligently than individual shareholders.[44] To this effect one of America's most prominent advocates of shareholder activism, the California Public Employment Retirement Systems (CalPERS) has organised

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43. SEC, Report For Senate Commission On Banking, Housing And Urban Affairs, 96th Cong., 2D Sess. Staff Report On Corporate Accountability, 383.

44.The reason for the illiquidity being that selling their large blocks of shares would depress the market and would prevent holders from realising the shares' true value - Wingerson M. and Darn C, Institutional Investors In The United States And The Repeal Of Poison Pills : A Practitioner's Perspective, 1992, 92 Colum. Bus. Law Rev., 223, 227.

the Council of Institutional Investors, which in 1989 had sixty three members.[45]

In 1986 the United Shareholders Association was founded in Washington D.C. with the purpose of encouraging shareholders in general and institutions in particular to take a leading role in corporate governance matters.[46] Institutional shareholders in the United States have also begun to create national organisations for pooling information and research on corporate policies. In 1985 a group of public and private pension funds trustees formed the Council of Institutional Investors to protect their rights as shareholders by collecting data and providing information to members.[47]

U.S. institutional investors have also sought direct influence over the appointment of non-executive directors of their companies. An example is the agreement by Texaco to select a board member from a list provided by CalPERS with the result that the President of New York University was added to the Texaco board.[48] Institutional pressure caused Exxon to name an

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45. White, CalPERS Chief Wields Big Stick For Institutional Shareholders, Wall St. Journal 3 April 1990 c.4

46. United Shareholders Association Fact Sheet, 56 Georgetown Law Journal, 1991/92, 84

47. Pension Funds Trustee Form Council, Washington Post, 25 January 1985 at 12 Col. 3

48. Flanigan J, Texaco Stresses The "Share" In Shareholder, L.A. Times, 25 January 1989 at D1, col. I

environmentalist to its board following the Exxon Valdez Oil Spill incident.[49] In addition, the United States Department of Labour (DOL) has promulgated guidelines to encourage corporate pension fund managers to vote their shares for purposes of fulfilling their monitoring role.[50]

Apart from the incentive of increased holding and arrangements by institutional organisations, the marked increase in management entrenchment in recent times has also fuelled institutional shareholders' activism.[51] Institutional intervention has been seen to occur when a company's management has been completely discredited and the ability of incumbent management to pursue the goals of the company is in question.[52]

This recent activism by large institutions has received recognition by legal writers. According to Charkham these moves by institutions at overseeing the management of their companies is keeping corporate managers on their toes. Describing managers' anger at these developments Charkham states:

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49. Wald M. L, Exxon Head Seeks Environmentalist To Serve On Board, N.Y. Times, 2 May 1989, at A1, col. 4

50. Interpretative Bulletins Relating To The Employee Retirement Income Security Act, 59 Fed. Reg. 38, 860 (1994) Codified at 29 C.F.R. s.2509

51. Duff C, K-mart's Embattled CEO Resigns Post Under Pressure From Key Shareholders, Wall Street Journal, 22 March 1995, at A3

52. Salwen K.G. and Lublin J.S., Activist Holders : Giant Investors Flex Their Muscles More At United States Corporations, Wall Street Journal, 27 April 1992 at A1, A6; Cowan A.L., Investors' Power Test At Borden, N.Y. Times, 13 December 1993 at D1

> " There seems little doubt that U.S. management is angry at the hint of greater shareholder activism and perhaps a little frightened judging by the vigour of its reaction"[53]

Lowenstein is of the opinion that institutional shareholders have awakened to their role in corporate governance and have created councils and other mechanisms for that very purpose.[54] Along these lines Matheson and Olson have stated that large U.S. institutions who are major players in the corporate governance arena, are now having direct influence over the control of their companies. [55] Confirming this point Blaire states :

> "Despite the multitude of legal constraints that have kept most financial intermediaries out of corporate board rooms, public employee pension funds, union pension funds, and a few other financial institutions have begun organizing themselves so that their voice would be heard."[56]

2. Limitations To Activism

Despite all these positive moves by institutional shareholders in the direction of more active monitoring of corporate management, there still are a number of factors which may mitigate against institutional intervention on a significant scale. An important question that needs to be asked is whether U. S.

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53. Charkham J., Keeping Good Company, 1995, 213, Clarendon

54. Lowenstein, Shareholder Voting Rights : A Response To SEC Rule 19c-4 And To Professor Gilson, 1989, 89 Colum. Law Rev. 979 at 981

55. Matheson J.H. and Olson B.A, Corporate Co-operation, Relationship Management And The Trialogical Imperative For Corporate Law, 1994, 78 Minn. Law Rev. 1443, at 1464

56. Blaire M.M, Ownership And Control, 1995, 165, Brookings

institutional shareholders are in a position to play a more effective role than they are currently undertaking. There are obvious reasons why this category of shareholders in the United States may find it difficult to be more actively involved in monitoring. These reasons include :

a) Regulatory Impediments

Institutions in the United States face significant constraint on their ability to take large shareholdings in companies.[57] With the enactment, in the U. S., of laws that limit financial institutions' ability to hold concentrated blocks of shares, a high level of institutional monitoring and supervision of management functions may be difficult. The Glass Steagal Act[58] which regulates banking businesses, prohibits commercial banks from owning and dealing in securities.[59] The Bank Holding Company Act which has been in force since 1956[60] prohibits banks and bank affiliates from holding more than five per cent of a company's shares unless the shares are non-voting. The Employee Retirement Income Security Act (ERISA) ensures that pension

57. Roe M.J, Political And Legal Restraints On Ownership And Control Of Public Companies, 1990, 27 Journal of Financial Economics 7

58. 48 Stat. 184 (1933) (codified as amended at 12 U.S.C. s.24 (Supp. 11, 1990))

59. Franzen C.A, Increasing The Competitiveness of United States Corporations : Is Bank Monitoring The Answer? 1993, 2 MINN. J. Global Trade, 271, 274

60. Its codified amendment is at 12 U.S.C. s. 1843(c)(6)-(7) (1988)

funds remain highly diversified.[61] Confirming the restrictive nature of the ERISA, Roe states:

> "Congress enacted ERISA ..... which, with no discernible governance-related motive, confirmed the pre-existing structure of corporate governance, by encouraging pensions to adopt the fragmented, passive stockholding structure that the three other big financial institutions - banks, insurers, and mutual funds - usually adopt."[62]

Several other laws also prevent mutual funds, pension funds, and insurance companies from controlling other companies through shareholding.[63] Commenting on the effect of these restrictions imposed on U. S. institutional shareholder Grundfest states that:

> "America seems not to trust her capitalists and for more than half a century State and Federal governments have limited investors' influence over the governance of publicly traded corporations. Investors' ability to monitor corporate performance and to control assets that they ultimately own has been subordinated to the interests of other constituencies ...... The persistent theme of this legislative trend is that society cannot trust stockholders and bondholders to promote the public interest. Society is better served, according to this view, if management is sheltered from the discipline that results from active capital-market oversight."[64]

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61. Pubublication No. 93-406, 88 Stat. 829 (Codified as amended at 29 U.S.C. ss. 10041-1161)

62. Roe M.J., The Modern Corporation And Private Pension, 1993, 41 U.C.L.A. Law Rev., 75, 76

63. Roe, M.J, A Political Theory Of American Corporate Finance, 1991, 91 Colum. Law Rev., 10, 12

64. Grundfest, J.A., Subordination Of American Capital, 27 Journal of Finance Economics 89-90

b) The Collective Action Problem

Institutional investors have the incentives to take collective action for the purpose of monitoring the activities of their companies in order to preserve the long-term value of their investments. The position is that they sometimes choose to pursue short-term passive investment strategies instead of grouping up to take collective and effective actions especially where activism turns out to be an expensive venture.[65]

Institutions will only contribute to collective good if the advantages or benefits are greater than the cost of providing that benefit. The existence of alternatives to collective action by shareholders such as selling off shares, investing in other viable and well-managed companies, or simply holding shares and not contributing to any aspect of corporate control constitutes a limiting factor.

Where the gains offered by one of the alternatives are greater than the benefits of monitoring management, shareholders are unlikely to engage in the latter. Institutions, like individual shareholders, are faced with the free-rider problem and the question is why should they undertake to monitor for the benefit of others when there often is rivalry between them? The cost of individual institutional action is likely to be high and unlikely to result in a

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65. Coffee J.C, Jr., The SEC And The Institutional Investor, (1994), 15 Cardozo L. Rev. 837 at 843

commensurate reward. Part of the reason for this is that there is no compulsory cost-sharing mechanism for shareholders wishing to object to management decisions or attempting to remove directors.

c) Inability To Monitor Effectively

One of the reasons why institutional investors do not intervene as often as they should is the organisational ability and skills required to monitor corporate managers. Staffing constraints mean that monitoring resources are usually allocated to emergency cases.[66] Where there is a mismatch between staffing and the size of shareholding by an institution then no serious monitoring can be expected. Institutions, in the circumstance, will be unable to ascertain whether the managers are doing a good job under difficult circumstance or whether the management team has made a vital mistake that cannot be remedied. Due to the lack of skills, institutional perception of management weaknesses will be tainted with uncertainty. In the face of such uncertainty institutions tend to intervene only at the crisis stage when there is a likelihood of change resulting from the intervention.[67]

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66. Roe M.J, The Modern Corporation And Private Pension, UCLA L. Review, 1993, 75, 104-7

67. Gourlay, R., Institutions Launch Bid To Oust Tace Board, Fin. Times, May 4, 1991, 10; Also Simms, J., Management: Investor Pressure Builds on all-in-one Executive, The Independent, Aug. 16, 1992, 19

d) Agency Problem

Although institutional investors now have increased holdings in their companies, it has to be recognised that institutions can only act through their agents, which involves practical problems and costs.[68] Commenting on this problem Short and Keasey have stated that:

> " Because the mechanics of institutional management mean that there is often a division between voting control of shares and the ultimate beneficial owner, agency problems of ownership and control arises at every level of the relationship between the beneficial and the final manager."[69]

Since voting decisions are made by individuals other than the owners or beneficiaries of the shares, the question is whether fund managers can be relied on to act in a way that maximizes the value of owners' investments. The choice that fund managers face is that they have to consider the benefits of acting in the interests of the beneficiaries and the costs of doing so. Due consideration must be given to the cost of monitoring management and that of organising other shareholders. The gains from monitoring activities would have to be substantial to justify such actions. Secondly, the time input necessary for effective corporate governance activities may be too costly for

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68. This agency problem may arise if institutions delegate investment management to fund managers. Problems may arise due to the competition among fund managers' interest in the annual league tables which is based on short-term evaluation while institutions emphasize the long-term value of the funds. - Rock, E.B., The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L. J. 445, 468-72 deals with this problem.

69. Short, H. and Keasey, K., Institutional Shareholders And Corporate Governance In The U.K., in Keasey, Thompson and Wright, Corporate Governance, 1997, 27, Oxford Press.

institutions.[70]

Due to the divergence of interests between fund managers (agents) and those of their principals one cannot assume that monitoring which may increase the value of the managed portfolio will be in the interest of the agents. There is very little (if any) economic incentive, therefore, for money managers to embark on monitoring corporate management. Evidence abound to show that portfolio managers rarely outperform the market with the result that assets are driven into passive (indexed) portfolios.[71]

e) Activism Might Trigger Moves To Exit

One of the potential dangers of approaching others to join a coalition is that it might trigger a panic by institutions to sell off their shares. The mere knowledge that a major shareholder is dissatisfied with management actions might have a negative effect on other institutional shareholders. It could induce other institutions to sell off in the fear that if the major shareholder did not secure satisfactory reform it might sell its shares and depress the prices. Black and Coffee have argued that the worry for causing a move by

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70. Gordon, L. A. and Pound, J., Gordon Group Inc., Active Investing In The U.S. Equity Market: Past Performance And Future Prospects, (1993), 2 at 14 assert that existing funds contemplate a holding period of three to five years which is a rather short period for intensive corporate governance activities.

71. It has been shown that CalPERS indexes 77% of its $22 billion United States equity portfolio and College Retirement Equities Fund (CREF) indexes approximately 80% of its $30 million equity portfolio - Bartlett, A California Pension Fund Cuts The New York Umblical Cord, New York Times, 26 August 1990, at F. 12 col. I

shareholders to sell off their shares and depress the market:

> "Forces the coalition builders to narrow the field of potential partners, thus further complicating the process of forming a coalition."[72]

In conclusion, there may be important factors which make monitoring difficult for institutions yet there are good reason for institutions to be active investors. It is obvious that the option of exiting becomes problematic as institutions increase their stakes in companies. In addition the potential buyer of an institution's shares is likely to be another institution and with the latter's full knowledge of the problems such a purchase is unlikely to happen.

D) GERMAN INSTITUTIONAL SHAREHOLDERS

Institutional investment in Germany is of a very distinctive nature. Among the categories of institutional holders already mentioned two are relevant to the German scene - insurance companies and banks. Endowments are non-existent, industrial foundations do not function as institutional investors, pension and investment funds have very little importance.[73] Although large German insurance companies have had some impact on public companies the most influential institutions have been the banks.[74]

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72. Black, B.S. and Coffee, J.C. (Jr), Hail Britannia?: Institutional Investors Behavior Under Limited Regulation, 1994, 92 Mich. L. Rev. 1997, 2062

73. Baums T.H, Banks and Corporate Control, 1993, Universitat Osnabruck Working Paper No 91-1, at 4

74. Roe M.J, Some Differences In Corporate Structure In German, Japan, and The United States, 1993, 102 Yale Law Journal, 1927 at 1968.

1. The Power Of German Banks

The background to the importance of German banks is that German securities market has been underdeveloped for much of the post-war period. This has given banks a position of influence since they constitute the largest single external source of capital.[75] The relationship between banks and other companies is normally a close-knit one. A bank's relationship with other companies may involve the following :

1. Providing the whole range of commercial and investment bank services;
2. Representing shareholders in general meetings by the use of proxies;
3. Having representatives on a company's supervisory board; and
4. Holding a substantial block of a company's shares.

Being a large creditor of a company gives a bank the ability to exercise control over management through the power to control the company's access to credit.[76] Until recently there have been considerable restraints on access to external non-bank finance by companies in Germany. The issue of long-term bonds was restricted by requirements under the issue authorisation procedure. These requirements included obtaining prior approval of the Federal Ministry of Economics before such bonds were made available.[77]

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75. Schneider-Lenné E.R, Corporate Control In Germany, 1992, 8(3) Oxford Review of Economic Policy, 11 at 18

76. Although this is not absolute power since the company could always go to another lender yet such a step would involve some cost of information acquisition to be borne by the company seeking the loan.

77. Monthly Report of the Deutche Bundesbank, March 1992, 47

Since debt finance constitutes a more important source of corporate finance in Germany than equity the result is that banks, as the main providers of capital, have additional influence to that attributable to ownership. This ability to influence corporate policies has been said to give banks the incentives to exercise active supervision in German companies. Consequently German shareholders rely on institutional precautions as a means of exerting control over corporate management.[78]

The depository voting rights through which banks vote the shares held by them for their customers, together with rights based on their own equity holdings, provide them with large voting powers which also enable banks to influence corporate policies.[79] Another reason for the large equity holdings by German banks is the close relationship with and encouragement by the government.[80] The three largest banks have enjoyed the support of the German government and are normally sure of being bailed out by it if

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78. Baums T, Corporate Governance in Germany : The Role Of The Banks, 1992, 40 A. J. Comp. L. 503 at 506 - states that German banks do classical banking businesses in addition to organising rescue operations for companies in financial distress, owning shares in companies and voting their clients share which together gives them the incentive to monitor; See also Parkinson, J.E. Corporate Power and Responsibility, (1993), 170, Clarendon

79. The three largest German banks - commonly known as 'universal banks' : Deutsche Bank, Dresdner Bank and Commerz Bank have great influence over German large companies - Buxbaum R.M., Institutional Owners And Corporate Managers : A Comparative Perspective, 1991, 57 Brooklyn Law Review 1 ; Harm C, The Relationship Between German Banks And Large German Firms, May 1992, Policy Research Working Paper, World Bank, 9

80. Tilly, R. H. German Banking, 1850-1914 : Developmental Assistance For The Strong, 1986, 15 J. Eur. Econ. Hist. 113

something goes wrong.[81] This support has given German banks the impetus to take more risks than banks in the U. K. and U. S., holding large blocks of shares, acting as lenders, sitting on the supervisory boards and voting as proxies of other shareholders. On this Artus comments:

> "My guess is that any conceivable increase in shareholder activity will not ..... match that of the bank-based economies, since share ownership unaccompanied by the additional involvement in providing finance and other services will never provide the depth of knowledge and commitment that arises with the combination of banking and proprietary interests."[82]

2. Weaknesses Of The Bank-Based System

Although the view has been that German banks may be in a better position to reduce mismanagement and fraud in their companies through active supervision[83] this idealised view is presently under serious doubt. The series of corporate failures involving large banks, and the conflicting interests that may occur when a German bank acts in its different capacities, have portrayed the weaknesses of the bank system. These weaknesses have

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81. Ibid at 117 where he discusses the involvement of German government in the growth and infuence of German banks.

82. Artus R.E, Tension To Continue, in Creative Tension? 1990, Nat. Assn. of Pension Funds Limited, 14

83. McCahery J., Picciotto S. and Scott C, (eds), Corporate Control and Accountability, 1993, 17, Clarendon Press

shaken the confidence of some of the enthusiasts for importing German methods of corporate governance to the U. K. and U. S. The next part highlights two aspects of the weaknesses inherent in the once much-praised German bank-based system of corporate control.

a) Corporate Failures

Germany has experienced a number of major corporate crisis in recent years. The problem appears to be that German institutions are very slow to act and often wait until their companies are in crisis before they take steps to bail them out or go to their rescue. The shock induced by the near-collapse of Metallgesellschaft, the Frankfurt-based industrial group which came to the brink of insolvency in January 1994 was amplified by the failure of the Schneider property group in April of the same year.[84]

In both cases the companies had close relationships with Deutsche Bank, Germany's biggest bank. While the Schneider case raised questions about Deutsche's lending procedures, the Metallgesellschaft issue brought under the spot-light the relationship between large banks and the companies in which they hold large blocks of shares and on whose supervisory boards they sit. Metallgesellschaft is owned by some of the most reputable institutional holders including Deutsche Bank, Dresdner Bank, the Allianz insurance

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84. Waller D., Frankfurts' Role Consolidated - Many Foreign Institutions Have Boosted Their Frankfurt Operations, Meanwhile, Pressure For Reform Of The Financial System Is Mounting, Financial Times, 31 May 1994, I

group and Daimler-Benz. According to Eisenhammer :

> "Together, Deutsche and Dresdner banks, Daimler-Benz and Allianz own over 40% of Metallegellschaft. The remaining big institutional shareholder is the government of Kuwait, with 20%. Deutsche Bank is also Metallegellschafts biggest creditor, to the tune of DM 539 million". [85]

Another serious crisis involved Daimler-Benz, then Germany's most important engineering and aerospace group which lost DM 5.7 billion. At Daimler's annual meeting in May 1996 Hilmar Kopper, who was the head of Daimler-Benz's supervisory board and the chairman of Deutsche Bank, was sharply criticised by shareholders for the fall of the company in which Deutsche Bank owned a dominant 24.4% stake.[86] In addition Klockner-Humboldt-Deutz, a household name in German engineering in which Deutsche Bank has a 47.7% stake, was in a situation where its survival was threatened following the discovery of an alleged multi-million pound fraud at a subsidiary - the Humboldt Wedag plant construction unit. It was said that the alleged fraud would have resulted in unexpected losses running to several hundred million Marks.[87] In the words of Tooher these :

> "embarrassments for Deutsche and its chairman, Hilmar Kopper, have raised doubts about the German system of corporate governance."[88]

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85. Eisenhammer J, A Supervisory Board That Could See No Evil, Independent, 17 January 1994, 28

86. Rodgers P, German Boards Under Scrutiny, Independent, 31 May 1996, 24

87. Tooher P, Huge Fraud Discovery At Deutsche Bank Subsidiary, Independent, 29 May 1996, 16

88. Ibid .

The idealised view of the German system is that bankers ensure that company managers have the finance for long-term investment and are shielded from the short-term pressures that stock markets bring to bear on companies in the U.K. and U.S. They are deemed to exercise their influence at various levels including sitting on supervisory boards, voting as proxies in general meetings and supplying finance to the company. The reality is that the mutual support that exists between banks and large companies results in a closely-knit unit which sometimes closes corporate Germany to the outside world. This sort of closed system harbours the danger of creating a cosiness which prevents those who are meant to scrutinise and control from playing that role effectively.[89]

b) Conflict Of Interest

The question has been how far the different functions of German banks, namely equity ownership, proxy voting and board membership, interfere with the interests of other groups in the company. As already indicated, and in addition to the above functions, the German banker issues loans to his clients, underwrites their equity in financial markets and markets these claims to the general public.[90] The result is three different areas which may bring

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89. Eisenhammer J, A Supervisory Board That Could See No Evil, Independent, 17 January 1994, 28

90. Harm C, The Financing Of Small Firms In Germany, 1991, 35

about serious conflict of interests. With these other business interests to consider banks are less likely to oppose management for fear of jeopardizing those interests and their business relationship with the company.

This potential conflict of interests that may result from banks' multiple roles may make it difficult for it to adequately represent its clientele since the interest of a bank as a lender might not coincide with the interests of the shareholders which it is representing. Commenting on this potential conflict of interest Otto Lambsdorff, a leading member of the German Free Democratic party stated :

> "The position and influence enjoyed by banks on supervisory boards is open to question as never before, ... They look after the company's capital market issues, they advise on mergers and acquisitions, and in some cases they own big share stakes as well. Is it surprising that their judgment as supervisory board members is clouded?"[91]

With institutional investors being themselves quoted companies, it may also be argued that institutions have good reasons for aligning themselves with the management of the companies that they have invested for fear of certain practices, which they themselves use, becoming unacceptable.

In addition, the involvement of large banks in detailed discussions with management, in their capacity as institutional shareholders, can bring up the

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91. Waller D, A Giant Burnt By Hot Metal : Metallgesellschaft's Ills Highlights The Failings Of Germany's System Of Corporate Governance, Financial Times, 24 January 1994, 13

issue of inequality of treatment of shareholders. The information and knowledge obtained by the participating institutions make them insiders who may take advantage of the ignorance of other shareholders that do not have access to such information. Apart from the issue of insider trading this can lead to a conflict between their interests and those of other shareholders.

3. Moves To Limit Bank Holdings In Other Companies

The interwoven relationships between German banks and industrial companies that many have admired as a model of corporate governance is now under review. Investors are of the view that, even with the amount of power that German banks have, they have not used their powers effectively.[92] There have been proposals to limit the amount of equity that German Banks can hold in other companies to 5%.[93] Along these lines some German states have introduced legislation aimed at limiting the powers of banks.[94] Apart from a more developed stock market, foreign banks have now increased their

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92. Parkes C, German Poll Finds Little Love for Banks, Fin. Times, Aug. 25, 1994, 19

93. Reuter, German Banks Under Fire, Fin. Times, Sept. 28, 1994, 2 states that Chancellor Helmut Kohl was concern about the complains of small companies that big banks were too powerful and on that basis wanted to limit bank holding and their representation on company boards; Also Chernoff, J. German Banks May Face New Rules, Pension and Investment, May 2, 1994, 42, asserts that investors believe that restricting the role of the banks would be a welcomed change.

94. The Bonn parliament introduced a legislation to this effect on the 26th of September 1997 - Norman P., German Banks Under Fire, Fin. Times, Sept 27, 1997, 3

businesses in Germany, giving corporate customers better opportunities of doing business more cheaply with other banks and raising money on the stock market. Stating this position Fisher writes:

> Shareholders are becoming less willing to accept the kind of return on equity and dividends that German banks have historically produced. Deutsche has led the way in adopting international accounting standards, which give banks less freedom to hide profits and reserves." [95]

CONCLUSION

So far the United States has not achieved the level of oversight of corporate managers by major institutions that is obtainable in the United Kingdom. In the United Kingdom banks, insurance companies and pension funds have not only increased their shareholding in recent times, but have become active in companies that they have invested in.[96] This level of concentration and cohesion by institutions found in the United Kingdom has been inhibited in the United States by the enactment of laws which limit the ability of large financial institutions from holding concentrated blocks of shares. Even if U.S. institutions desired to be more active in their interventionist role the prevalent obstacles would inhibit continuous monitoring on a significant level.

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95. Fisher A. , German Banking and Finance: Institutions Face A Painful Transition, Fin. Times, May 29, 1996, 4

96. Denis, D.J. and Denis D.K., Majority Owner-Managers and Organisational Efficiency, 1994, 1 Journal of Corporate Finance, 91, 102-5; See also Jackson,T., The Institutions Get Militant, Fin. Times, June 11, 1991, 18;

Despite the lack of legal restrictions in the United Kingdom institutional activism is sometimes constrained by the costs associated with forming and maintaining shareholder coalitions. As a result United Kingdom institutions are, comparatively, less involved in monitoring and determining board composition than their counterparts in the bank-based German system.[97] Oversight is deemed to be more thoroughly undertaken by German banks when compared to U.K. and U.S. due to their roles as both equity holders and lenders. Institutional investors in the Anglo-American system, therefore, lack the incentives enjoyed by German banks which flow from their multiple roles. German banks may acquire and hold shares in non-bank companies as there are no rules comparable to the United States Glass-Steagall Act or the Bank Holding Act which limit shareholding by certain institutions.

The practice of appointing institutional representatives to corporate boards is not as common under the Anglo-American system as it is in Germany. The present emphasis on non-executive directors, who are generally selected by and owe their tenure to the management[98] cannot be equated with this and does not solve the problem of monitoring management indiscretion.

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97. Parkinson is of the view that the key factor which may move German banks to exercise an active ownership role is their stable long-term interests which is reinforced by their multifaceted functions. In comparison U.K. institutions have a much more limited relationship with their portfolio companies - Parkinson, J.E., Corporate Power And Responsibility, 1993, 171, Clarendon Press

98. Chapter Five on Board Structure and Shareholders Representation On Corporate Boards discusses this position.

Through representation on the supervisory boards German institutional shareholders are supposed to have a formal channel for intervention. They are, however, slow to act with the result that intervention is only undertaken when a client is in serious trouble. On this basis it has been stated that the banks are too relaxed and cosy in their different roles that they fail to see a crisis coming until it actually arrives.[99]

These different limitations on the ability of institutional shareholders to intervene in the affairs of their companies have brought about some level of convergence in institutional behaviour and attitude. Vocal shareholder activism, the American style of intervention, is now being increasingly used in the United Kingdom.[100] In addition, United Kingdom institutions have observed their United States counterpart's insistence on audit committees and the dominance of independent, outside directors on the boards and are now pressing for similar changes in U. K. companies.[101] On their part, U. S. institutions are now following the example of their counterparts in the U.K. to insist on the separation of the positions of chairman of the board and the chief executive officer.[102]

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99. Harm, C. supra at note 79 at p. 12

100. Miles R, Stirrings of Activism In The United Kingdom, Summer, 1993,. Georgeson Rep., 3, Georgeson & Co., New York,

101. Oxford Analytica Ltd., Board Of Directors And Corporate Governance : Trends In The G7 Countries Over The Next Ten Years, 1992, 62

102. Fuchsberg G, Chief Executives See Their Power Shrink, Wall Street Journal, 15 March 1993, at B1.

There have also been attempts by German banks to limit their holdings in individual companies thus reducing the excessive powers exercised by such banks. According to Ellen Schneider-Lenne, a member of Deutsche Bank's management board, who is also on the boards of I.C.I. and Morgan Glenfell in the United Kingdom, German companies are now learning from the practices of Anglo-Saxon institutional holders and company boards.[103]

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103. See Views From City Road : Why Germans Are Offered British Role Model, Independent, 10 February 1994 at 40.

CHAPTER FOUR

APPOINTMENT AND REMOVAL OF DIRECTORS : THE LEGAL AND REGULATORY FRAMEWORK

A) INTRODUCTION

Early capitalism consisted typically of entrepreneurs who ran their own businesses[1]. In the more recent past there has been the growth of publicly-quoted companies and the tendency towards dispersed ownership of shares with a consequent weakening of the links between ownership and control of companies.[2] With management powers being exercisable by directors, shareholders have very little influence over the day-to-day running of their company. In an attempt to give back to shareholders some level of control over the management of their funds, regulations and statutes have vested in them the powers to appoint and remove directors.[3]

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1. Fried, V. and Hisrich, R., The Venture Capitalist: A Relationship Investor, 1995, 37/2, California Management Review, 101, 109

2. For a discussion of separate objectives of management and shareholders see Dimsdale, N.H., The Need to Restore Corporate Accountability: An Agenda For Reform, in Dimsdale and Prevezer, Capital Market and Corporate Governance (eds), 1994, 17, Clarendon Press

3. Tricker argues that the most fundamental right of shareholders in terms of the traditional legal model is the right to elect the board of directors to serve and protect their interest – Tricker, R.I., International Corporate Governance, 1994, 10, Prentice Hall

Shareholders' role in corporate control is exercisable by them collectively through their right to vote. Their voting rights should provide them with some protection against the abuse of managerial indiscretion by enabling them to remove directors with whom they are dissatisfied. The potential power of shareholders' voting rights underlies the so-called 'market for corporate control'[4] which is supposed to neutralise the discretionary powers exercisable by corporate management.

For a meaningful discussion of the powers of the general meeting to appoint and remove directors a discussion of the statutory and regulatory rules becomes necessary. This chapter will examine the provisions which entitle shareholders to appoint and remove directors in the U.K, U.S. and Germany.

B) APPOINTMENT AND REMOVAL OF DIRECTORS UNDER U.K. LAW

The current legislative framework is to be found in the Companies Act 1985 as amended by the Companies Act 1989. These are based on earlier Acts

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4. This theory posits that shareholders influence the board of directors and the management of their company through the ability to sell their shares thereby lowering the value of their company shares. A company's management has good reason to be concern if the share prices go down as such developments would encourage threats of take-over and the adverse publicity that goes with it. – Bradley, Corporate Control: Markets and Rules, (1990) 53 MLR 170; Coffee, J.C., Regulating The Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 1984, 84 Colum L. Rev. 1145; Parkinson, J.E., Corporate Power And Responsibility, 1993, 119, Clarendon Press

which date back to the 1844 Joint Stock Companies Registration Act.

1. Power To Appoint Directors

At formation the incorporators have to deliver to the registrar of companies a list of the persons that are to be the first directors of the company with the memorandum of association.[5] The statement is required to be signed by or on behalf of the subscribers to the memorandum. The persons nominated to act as first directors are required to sign the statement to show their consent to the appointment[6]. Subsequent to the incorporation of a company, the Companies Act has very little to say about the appointment of directors and the matter is left mostly to the articles of companies.

a) Appointment By The General Meeting

Table A article 78 empowers the general meeting of shareholders to appoint directors by passing an ordinary resolution. Where the general meeting of a public company is to appoint more than one director to the board they must be voted for individually otherwise the resolution will be void[7]. This power of

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5. Section 10(2)(a) Companies Act 1985

6. Section 10(3) Companies Act 1985

7. Section 292 Companies Act 1985

appointment as given by article 78 is to be exercised for the benefit of the company as a whole and not to secure a personal advantage. This fiduciary duty imposed on shareholders introduces a clear contrast to the old position where the right to vote at general meeting was regarded as a right of property which a shareholder could exercise in his own interests even where they conflicted with those of the company.

Walton, J. had stated the old position succinctly in Northern Countries Securities Ltd v. Jackson and Steeple Ltd[8] thus:

> "when a shareholder is voting for or against a particular resolution he is voting as a person owing no fiduciary duty to the company and who is exercising his own right of property to vote as he thinks fit. The fact that the result of the voting at the meeting will bind the company cannot affect the position that in voting, he is voting simply in exercise of his own property rights........."[9]

The present position is, however, that in exercising their powers the majority shareholders must, within the broad limits, exercise them for the benefit of the company as a whole and not to secure some ulterior advantage.[10]

The provisions of article 78 aim at vesting in the general meeting an inherent power to appoint directors thus giving it the ability

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8. (1974) 1 W.L.R. 1133

9. At p. 1144

10. The majority shareholders are sometimes constrained to act bona fide in the common interest, examples are when altering the articles or varying class rights.

to determine the composition of the board. One is, however, tempted to ask why such an important matter is not made a provision in the statute? Why is this power, as given to shareholders, left to be regulated by the articles when a company has the discretion to decide not to be regulated by the standard form articles of Table A or to have a completely different clause in its articles of association?

b) Appointment By The Board

There are two instances when the power to appoint a director can be exercised by the board - when a casual vacancy occurs on the board and where the board has not achieved the required minimum number of members.

i. Filling Of Casual Vacancies By The Board

Corporate directors are entitled to co-opt directors to fill casual vacancies. Fry J. in Munster v. Cammell Co[11] defined a casual vacancy as " Any vacancy in the office of directors arising other than through retirement by rotation." In York Tramways Co. Ltd v. Willows[12] Coleridge C.J. observed that a casual vacancy is " any vacancy not occurring by death, resignation or bankruptcy".

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11. (1882) 21 Ch. D 183 at 187

12. (1882) 8 Q B D 686 at 694

A vacancy on the board which occurs other than by the regular expiration of a director's term of office will be deemed a casual vacancy. Where a casual vacancy is not filled before a general meeting it may be filled then, and if not, the power remains with the board of directors.[13]

At first glance the provision dealing with the filling of vacancies by directors appears to be simply one of technical interest. In reality it is extremely significant for management or any other group seeking to strengthen its control over a company. A regulation of this kind has the effect of preventing shareholders from exercising their right to appoint directors to the board. It may be that the directors' terms have not yet expired or that the next shareholders' meeting for the removal of old and appointment of new directors will only take place after a certain period. In such situations the use of directors' power, under the articles, to fill vacancies will be called into play. The normal practice is that at a subsequent meeting the shareholders will simply confirm the appointment with the effect that shareholders are deprived of the power to actually determine the calibre of persons appointed to sit on their boards.

One of the techniques used by directors to ensure that this power is actually exercised by them is by getting their colleagues on the board to retire

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13. Munster v. Cammell Co. (1882) 21 Ch D 183

mid-term or long before a general meeting is due hence giving themselves the opportunity to fill the vacancy[14]. This practice enables existing directors to have control over the future composition of the board. The justification that has been offered for this is that directors must act collectively as a board in the management of the company and that the board usually operates better if it is a group of like-minded and compatible individuals[15].

ii. Appointment Of Additional Directors By The Board

Under U.K. law directors are normally vested with the power to appoint additional directors by the articles.[16] Where the articles of a company entrust directors with this power even the general meeting cannot usurp the power. In Blair Open Hearth Furnace Co.v. Reigart[17] the company's articles of association provided that the directors may from time to time appoint additional directors, but so that the total number of directors shall not exceed the prescribed maximum. Eve, J. held that by the provision of that article the power of appointing additional directors had been divested from the general meeting and entrusted in the board of directors.

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14. Mercer D., IBM: How The World's Most Successful Corporation Is Managed, (1987), 15-18, (Kogan Page, London); Clinnard, M.B., Corporate Corruption: The Abuse of Power, 1990, 21-24, Praeger.

15. Zimmers Ltd v. Zimmer [1951] WN 600

16. Art. 79 of Companies (Tables A - F) Regulations 1985

17. (1913) 29 LTR 449.

The position with regard to the appointment of additional directors is, therefore, that once a company is regulated by article 79 or an equivalent article, the power to appoint additional directors, to meet the required minimum will be exerciseable by the board of directors. The general meeting can only override this power as conferred on the directors by way of a special resolution for purposes of altering the articles.

There are, however, two exceptional situations when this power can be exercised by the general meeting:

a) Where the power could not be exercised by the directors owing to dissension or deadlock on the board. In Barron v. Potter[18] Warrington J. decided that where a board was unwilling to exercise a power to appoint additional directors, the company had power to do so in general meeting.

b) Where the power to appoint additional directors is a concurrent power to be exercised either by the board of directors or the general meeting of shareholders.[19]

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18. [1914] 1 Ch 895

19. In Worcester Corsetry Ltd v. Witting [1936] Ch. 640, the articles of a company gave a concurrent power to both the board of directors and the general meeting of shareholders. Distinguishing this case from Blair's case the court held that the power of appointing additional directors had not been delegated to the board to the exclusion of the general meeting.

2. Shareholders' Power To Remove Directors Under U.K. Law

Prior to the passage of Section 184 of the Companies Act 1948 shareholders were not able to remove a director by an ordinary resolution before the expiration of his term of office unless the company's Articles of Association made provisions for their removal. It was common at the time for companies to provide in their articles for life directors, and permanent directors who could only be removed by an alteration of the articles. That position was altered in 1948 by Section 184(1)[20] which provided inter alia :

> "A company may by ordinary resolution remove a director before the expiration of his period of office, notwithstanding anything in its articles, or in any agreement between it and him."

This provision was introduced pursuant to the recommendations of the Cohen Committee that shareholders should be given "greater powers to remove directors with whom they are dissatisfied"[21]. This was one of the means by which the Cohen Committee hoped to grant shareholders some measure of control over the management of their companies. The intention of the provision was to prevent articles of companies from making directors irremovable and to render impossible the appointment of life directors. Section 303 of the Companies Act 1985 which replaced S.184 of the 1948 Act, has continued the task of its predecessor by giving shareholders the

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20. Companies Act 1948

21. The Cohen Committee Report (Cmnd 6659, 1945) para 130

right to remove their directors by simply passing an ordinary resolution[22]. There are, however, a number of ways by which directors can avoid the effect of this section. The following indicate the difficulties that shareholders can face when they wish to exercise their rights under this provision.

a) The 'Just And Equitable' Winding-Up (Section 122(1)(g) Insolvency Act 1986)

A serious check on the exercise of shareholders' power to remove directors under Section 303 is the provision of Section 122(1)(g) of the Insolvency Act 1986. This subsection enables a winding-up order to be made if "the court is of the opinion that it is just and equitable that the company should be wound up." The effect of this is that if a company has been set up and developed by a small group of people, the founders have an equitable interest in participating in the management of its business.

This affects shareholders' power of removal under Section 303 in that a court may order a winding-up on the ground that it just and equitable to do so even though it has no jurisdiction to declare a resolution for the removal of a director invalid.

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22. See the provisions of Section 303 Companies Act 1985

A court can wind-up a company in these circumstances if it believes that the company in question was incorporated and operated as a quasi-partnership. If the court finds that the relationship, which is so important to the continued existence of the company, has completely broken down it may order its winding up, thus subjecting the exercise of legal rights to equitable considerations.

This principle was considered in this specific context in the case of Ebrahimi v. Westbourne Galleries Ltd[23]. In that case a minority shareholder, the appellant, was removed from office by a resolution passed by the general meeting. The appellant petitioned the court for a winding-up order on the just and equitable ground. Granting the order in the court of first instance Plowman J stated :

> " ... it is an abuse of power and a breach of the good faith which partners owe to each other to exclude one of them from all participation in the business upon which they have embarked on the basis that all should participate in its management."[24]

Russell L.J., in the Court of Appeal, reversing that decision pointed out that the exclusion of a director from participation in the management and conduct of company's business does not form a ground for holding it just and equitable that the company be wound-up.

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23. [1972] 2 AER 492

24. [1970] 1 WLR 1378 at 1389

The House of Lords reversed the decision of the Court of Appeal holding that a petition to wind the company up on the just and equitable ground would succeed if the petitioning director could show that the business was operated on the understanding that he would be entitled to participate in its management. It found that although the shareholders had acted within their legal rights in removing Ebrahimi, since the company was formed on the basis that they were to have joint participation in its management, the only just and equitable course was to wind-up the company. The position is, therefore, that if members of a private, quasi-partnership type of company pass a resolution under Section 303 to remove a director they run the risk of a dissolution of the company under this subsection.

This approach by the House of Lords has been followed in Re A and BC Chewing Gum Ltd.[25] Here the minority shareholder was entitled, under the articles and by virtue of a separate shareholders' agreement, to appoint one director to the board but the majority refused to give effect to the appointment. Plowman J., relying on Ebrahimi's case, held that the company should be wound-up as the majority had repudiated the minority's right to participate in the management of the company, a right which was the underlying basis in the formation of the company.[26]

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25. [1975] 1 All ER 1017,

26. A more recent application of the Ebrahimi principles is to be found in Re Zinotty Properties Ltd [1984] 3 All ER 754, where the court found as evidence of breach of the required trust and confidence, among other things, that A had not been appointed as a director as he was entitled to expect.

b) Unfairly Prejudicial Conduct (Section 459 CA 1985)

Section 459 of the Companies Act 1985 which can be traced to Section 210 of the 1948 Companies Act has itself been amended by the Companies Act 1989. Section 459, as amended, provides:

> "A member of a company may apply to the court by petition for an order under this Part on the ground that the Company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or some part of the members or that any actual or proposed act or omission of the company (including any act or omission on its behalf) is or would be so prejudicial."[27]

The use of the word "unfairly" in Section 459 enables the court to have regard to some equitable considerations in the same way as the House of Lords did in Ebrahimi's case. In Re Posgate and Denby (Agencies) Ltd[28] the court emphasised that the concept of unfair prejudice in Section 459 enables the court to take into consideration not only the rights of the members under the company's constitution, but also their legitimate expectations arising from agreements and understanding of the members inter se.

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27. Amended by CA 1989, Sch 19, para 11. It replaces the previous requirement which was that the conduct had to be prejudicial to the interests of some part of the members.

28. [1987] BC LC 8

This section is concerned with the interests of members in their capacity as members.[29] In an attempt to identify the interest of members in a particular situation the courts will take into account the relationships, rights, obligations and expectations of the parties involved. In Re Sam Weller & Sons Ltd,[30] Peter Gibson J. observed that the word 'interests' is wider than a term such as 'rights'. In that case the petitioners complained that the company had not increased its dividend in 37 years despite having been prosperous in recent years. In 1985, out of the net profits of over £36,000, it had paid out only £2,520 in dividends. The court ruled that the non-payment of dividends constituted unfairly prejudicial conduct. In Re a Company, ex p Schwacz (No. 2),[31] the court stated that:

> " the relevant interests are the interests of members (including the petitioners) as members, but such interests are not necessarily limited to strict legal rights under the company's constitution and the court may take into account wider equitable considerations such as a member has which go beyond his legal rights."[32]

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29. In Re A Company [1986] BCLC 382, failure by the directors to advise shareholders impartially regarding two competing take-over bids was held to constitute unfairly prejudicial conduct

30. [1990] Ch. 682,

31. [1989] BCLC 427

32. Ibid at p. 437

Section 459, therefore, protects legitimate expectations which are based on an informal agreement among all the members and not provided for in the articles. A range of expectations may be protected through the use of this section. The most common one is where the petitioner had expected to have a continuous involvement in the management of the company by sitting on the board. For a court to uphold such an expectation there has to be a clear demonstration of an agreement or informal arrangement which is outside the provisions of the articles.[33]

Under the old section 210 of the Companies Act 1948 a petitioner who complained of removal from the board and exclusion from management was not entitled to any relief since he was not oppressed 'qua member' as was the requirement under that section[34] Since Section 459 has no such limitation a petitioner who now makes the same complaints may obtain a relief under this section. The position will, however, vary greatly from small private or family companies to the large public companies since a small family company would have been formed or continued on the basis of a personal relationship involving mutual confidence and understanding.

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33. Re Saul D. Harrison & Sons plc [1995] 1 BCLC 14 at 19; Re Posgate and Denby (Agencies) Ltd [1987] BCLC 8; Currie v. Cowdenbeath Football Club Ltd [1992] BCLC 1029

34. Re Lundie Bros Ltd, [1965] 2 All E R 692; See also Re London School of Electronics Ltd. [1972] 2 A.C. 165

c) Directors' Compensation And Remuneration

Another limiting factor on the power of the general meeting to remove a director under Section 303 is the provision that the section shall not deprive a director of any claim for compensation or damages in respect of the termination. Section 303(5)[35] provides that where an executive director has a service contract with the company and he is removed in breach of that contract, the provision of the law which enables the general meeting to remove him will not prevent him from suing to claim damages for breach of contract.

The provision of this subsection was upheld in Southern Foundries (1926) Ltd v. Shirlaw and Fowler Commercial Timber Company.[36] The main question was whether the removal of the managing director who was appointed by the board under a service contract for a specific period constituted a breach of his contract which entitled him to claim damages.[37] Where, on the other hand, a director does not have a separate service contract and was appointed under the articles, he will not be entitled to recover damages on removal

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35. Section 303(5) Companies Act 1985

36. [1930] 3 KB 1

37. Also Shindler v. Northern Raincoat Co. Ltd, [1960] 2 All E R 239 which followed the decision in Shirlaw's case

from the board.[38]

The provision of Section 303(5)[39] constitutes a serious restraint on shareholders' power to remove directors in that in removing directors before the expiration of their term, members are taking the risk of imposing on their company liabilities for damages in breach of contract. Since directors actually appoint the executives and fix the terms of their contracts, members may later find that directors have entrenched themselves by contracts of service with the result that the company has to pay exorbitantly if members exercise their power under Section 303.

Knowledge of the huge damages that may be payable by the company in the event of such a director being removed from the board may constitute sufficient deterrence to shareholders. Even with the present requirements that directors' service contracts are to be available for inspection by members[40] and that contracts which exceed five years must be given prior

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38. In Read v. Astoria Garage (Streatham) Ltd, [1952] Ch 637, one of the company's articles stated that the directors may appoint the managing director for such term and at such remuneration as they thought fit. His appointment was to be subject to termination by the company. Read was appointed managing director and seventeen years later was removed from the board. It was held that he had no claim for damages.

39. Companies Act 1985

40. Section 318 CA 1985

approval by the general meeting[41], by controlling the voting machinery such an approval would not be difficult to obtain.

i) Statutory Controls

To avert any abuses that may flow from the exercise of directors' power to fix the remuneration of the executive members, the Companies Act requires every company to keep a copy of each director's service contract at an appropriate place.[42] Where a director has no written contract a written memorandum of the terms on which the director serves must be kept.[43] Members of the company may inspect copies of directors' service contracts or memoranda of terms of service without any charge.[44] Where inspection is refused the court may order it to be allowed. [45] In addition, Section 319[46] requires that shareholder approval must be obtained for any provision whereby a director is to be employed for a period which exceeds five

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41. Section 319 CA 1985; The Cadbury's Report recommends that such contracts should not exceed three years - para 4.41 of that Report.

42. Section 318 (1)(a) & (3) of the Companies Act 1985; Appropriate places for this purpose are the company's registered office, the place where its register of members is kept, or its principal place of business, where that is situated in that part of Great Britain in which the company is registered.

43. Section 318 (1) (b); There is no requirement for a copy or a memorandum to be kept where a contract is for a duration of less than 12 months – Section 318(11).

44. Section 318(7)

45. Section 318(9)

46. Companies Act 1985

years without being terminable by the company or terminable only in specified circumstances. Where shareholder approval is sought a memorandum of the proposed agreement has to be made available for inspection by members, without a charge, at the company's registered office for at least 15 days before the meeting and during the meeting.[47]

Where approval is not obtained in contravention of this section the agreement will be terminable by the company giving reasonable notice.[48] This section does not prohibit lengthy service contracts but simply subjects them to the approval of the company in general meeting. Where the directors are also the shareholders in a private company this section will not be in issue as the member-directors will simply decide from time to time how much to pay themselves. Recent occurrences have proved these statutory controls to be inadequate.[49] 1994 saw more publicity of these practices when directors' remuneration, especially those of the privatized utilities, raised public concerns. The directors of those companies awarded themselves generous salaries and stock option packages in the face of redundancies, salary

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47. Section 319(5)

48. Section 319(6)

49. Sheikh, Curbing Top Pay Bonanza, 1995, Co. Law 117; Major Set To Tackle Executive Pay Deals, Daily Tel., Mar. 1, 1995, p.1

cuts and dismissals of some of their employees[50]

ii) The Contribution of the Greenbury Committee

As a result of public outcry against these practices by top directors the government set up a 'study group' chaired by Sir Richard Greenbury with a term of reference:

> " to identify good practice in determining directors' remuneration and prepare a Code of such practice for use by U.K. PLCs"[51]

One of the important recommendations of this study group is that companies should replace share option schemes with payment in shares to directors whose company meets financial and share-price targets as they are likely to align directors' compensation with corporate performance[52]. Another important recommendation is that which requires all U.K. listed companies to establish remuneration committees consisting exclusively of non-executive

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50. The Great Utility Scandal, Times, Feb.8, 1995, p.16; House of Commons Employment Committee, Third Report: The Remuneration of Directors and Chief Executive of Privatized Utilities, (1995), para 23, n. 85

51. Study Group on Directors' remuneration - Report and Code of Best Practice, (1995), Greenbury Report, London: Gee & Co.

52. Para. 4.4 of the Greenbury Report; See also Lewis, W., Directors Tips Too Generous For Investors, Fin. Times, Aug. 6, 1996, 6

directors.[53] These remuneration committees would determine both the company's general remuneration policy and the pay packages of individual executive directors.

Although the Greenbury Report aimed to subject the determination of executive remuneration to an acceptable yardstick, the effect has not yet been felt. Despite moves by companies to set up remuneration committees, it has been noted that there is still a significant executive presence on such committees.[54] In addition the non-executives, who are supposed to man these committees, are often executive directors of other companies and may not be stricter in their role of formulating directors' remuneration policies than they would be when tackling other policy decisions as board members. The result is that the executive directors still have an upper hand in determining their own pay and this is not always linked to the performance of a company. In this regard the issue of executive compensation when removing directors with long-term contracts and large remuneration packages still remains a burning issue.

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53. Para 4.8 of the Greenbury Report; The Code of Practice produced by this committee appears as an annex to the Stock Exchange's Listing Rules and para 12.43(w) of the Listing Rules now requires listed companies incorporated in the U.K. to state in the annual report whether they have complied with Section A of the Code and to "explain and justify" any area of non-compliance.

54. Conyon emphasizes that for those companies with remuneration committees executive directors are still appointed to sit on them with the result that members of remuneration committees could be dominated by the executives who may make decisions that are in management rather than shareholders interests.- Conyon, M.J., Institutional Arrangements For Setting Directors' Compensation In U.K. Companies, in Keasey, Thompson and Wright, Corporate Governance, 1997, 112, Oxford University Press.

3. Removal Of Directors By The Board For Reasonable Cause

The articles of a company may provide for dismissal of a director without special notice[55]. It is common for the articles to provide that a director can be removed by the board for reasonable cause. In Inderwick v. Snell,[56] the court held that the expression reasonable cause refers to any cause deemed reasonable at the time and that the court had no jurisdiction to interfere.[57]

C) APPOINTMENT AND REMOVAL OF DIRECTORS IN THE U.S.

1. Appointment Of Directors

In the absence of any provision in the charter of a company or the general law, the general meeting of shareholders has the inherent power to appoint directors annually.[58] In jurisdictions following the Model Business Corporation Act directors are appointed at the first annual general meeting and at each

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55. Special notice means that the person intending to move a resolution is required to give the company at least 28 days notice before the meeting at which the resolution is to be moved - Section 379(1) Companies Act 1985.

56. (1850) 19 L J Ch 542,

57. See also Lee v. Chou Wen Hsien [1984] 1 WLR 1202.

58. S.8.03(d) RMBCA 1984. In the Utah case of Hinckley v. Swaner, 13 Utah 2d 93, 366 P 2d 709, it was held that the appointment of directors is a right to which shareholders are entitled, and a court has no power to preclude shareholders from the full exercise of such a right.

annual general meeting subsequently unless their terms are staggered.[59] The directors of a private company are generally appointed in accordance with the procedure of nomination and vote at general meetings, in the absence of contrary provisions in a charter or by-law.

The by-law may provide that the directors be divided into two or more classes whose terms of office shall respectively expire at different times.[60] A company can be precluded by its by-laws from appointing directors where it has not fulfilled certain legal requirements such as presenting the annual accounts, ceasing to do business or becoming insolvent.[61]

a) Initial Directors

The Revised Model Business Corporation Act, 1984 provides that the names and addresses of the initial board members are to be stated in the articles of incorporation and such persons are to hold office until the first annual general meeting at which their successors are appointed.[62]

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59. See s.8.03 Rev. Model Business Corporation Act 1984; s.10-2A-58 Ala. Code 1987; Ss.33-314 and 33-315 Conn. Gen. Stat. 1987; Chap. 32, para 8.10 Ill Rev Stat. 1993; Ss.23-1-33-3 to 23-1-335 Ind. Code 1989; and S.79-4-8.03 Miss. Code Ann 1989. A staggered board is one which is divided into several groups or classes with the term of office of each class expiring at different annual meetings.

60. Solomon, L.D. and Palmiter, A. R., Corporations, 1994, 182, Little Brown

61. The Michigan case of Bruun v. Cook, 280 Mich. 484, 273 NW 774 upheld this position.

62. Section 8.05(a) Revised Model Business Corporation Act 1984

Most jurisdictions in the United States have similar provisions[63]

b) Subsequent Directors

Subsequently the board is elected by the shareholders who have voting rights. The usual term provided by State Statutes is one year or until another board is chosen and takes office. The majority of statutes provide that, unless the articles or by-laws provide otherwise, the directors need not be shareholders in their company.[64] There seems to be a move by most of the states towards statutory provisions on classified directors. The operation of this system is such that if there are nine directors, for example, the first three may be appointed for three years, the second three for two years and the last three for one year. To this effect the Ohio Gen. Corporation Law provides :

> "The articles or the regulations may provide for the classification of directors into either two or three classes consisting of not less than three directors each, and that the terms of office of the several classes need not be uniform, except that no term shall exceed the maximum period (three years) specified in division (A) of this section."[65]

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63. See for examples S.10-2A-58, Ala. Code (1987); S.10.06 453d Alaska Stat. (1989); S.4-27-805 Ark. Code Ann. (1990); Cal. Corp. Code S. 301, 1990.

64. An example is S.371, Maine Gen. Corp. Law 1992

65. Section 1701-57B Ohio Revised Code (1986 Suppl.).

In the absence of provisions to the contrary, the power to appoint directors is in the shareholders provided that the company is doing business and has the authority to issue shares.[66] In some states failure to pay dividend to preference shareholders will entitle that class to elect a certain number of directors to the board. In the Delaware case of Petroleum Rights Corporation v. Midland Royalty Corporation[67], it was held that failure to pay dividend as provided in the certificate of incorporation gave preference shareholders the right to elect a certain number of directors.

c) Vacancies On The Board Of Directors

Under statutory authority by-laws are usually adopted that provide for the filling of vacancies which occur on the board and the general provision of such by-laws is that vacancies shall be filled by the board of directors[68]. If the statute authorizes the board of directors to fill vacancies, the board may accept the resignation of a director and elect a successor[69] and may also

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66. In the Alabama case of Holcomb v. Forsyth, 216 Ala 486, 113 So 516, the court emphasized that the right to control the election of members of the board is a right inherent in majority ownership of shares.

67. 19 Del. Ch. 334, 167 A 835.

68. An example is S.223(a) Del. Code Ann (1991).

69. Seal of Gold Min. Company v. Slater, 161 Cal. 621, 120 P 15

elect a new director where the number falls below the minimum fixed[70]. This right as vested in the board of directors, to select corporate officers cannot be precluded by a shareholders' agreement[71].

The by-law will normally provide that any vacancy on the board of directors, whether arising through death, resignation, removal or through an increase of the number of directors of any class, shall be filled by a majority vote of the remaining directors[72]. There are however instances when the courts have given shareholders the power to fill such vacancies. In Byerly v. Camey[73] the Texan Civil Appeal Court held that where directors, who had power to select successors, died without making the selection the shareholders had the power to fill the vacancy.[74]

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70. Wright v. First National Bank, 52 NJ Eq 392, 28 A 719.

71. In the New York case of Schmidt v. Magnetic Head Corporation, 97 App. Div. 2d 151, 468 NYS 2d 649 despite the contention of shareholders who owned 45.8% of the company's shares that they were entitled to select at least one-third of the board of directors during the existence of a particular shareholder agreement, it was held that such an agreement was inconsistent with the authority vested in the board of directors by statute and therefore ineffective for that purpose.

72. Homac Inc. v. DSA Fin, Corp., 661 F Supp 776

73. 180 Tex. 2d 831 (App)

74. In the case of Burr v. Burr Corp.,50 the Delaware court, construing Section 223 of the Delaware Code Ann tit 8 (1991) emphasized that since the by-laws so permitted, shareholders had the power to fill vacancies on the board of directors if directors remaining in office failed to exercise this power within 60 days.

In addition, vacancies occurring on the board by reason of the removal of directors without cause may only be filled by shareholders unless the articles or by-laws provide that the vacancy should be filled by the board. Modern statutes often give the board of directors the power to appoint new members to its body upon the death or resignation of a director[75]. The new member is normally appointed to serve until the next annual general meeting when directors will be appointed.

2. Removal Of Directors

Under U. S. law whether a director can be removed before the end of his or her term of office is a question governed by the company's charter, the by-laws, applicable shareholder agreements and the local business corporation statutes[76]. Company statutes of several states provide that any officer or agent may be removed by the board of directors whenever, in its judgment, the best interests of the company will be served but the removal shall be without prejudice to the contract rights, if any, of the person so removed[77].

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75. See for example S.705(b) NY Business Corporation Law (1986)

76. Springut v. Don & Bob Restaurants of America, Inc., 57 AD2d 302, 394 NYS2d 971.

77. Section 10-051 Ariz. Rev. Stat. Ann. 1990; S.30-1-51 Idaho Code 1993; Ch. 32, para 8.55 Ill. Rev. Stat. 1993; S.496A 46 Iowa Code 1991; S.35-1-411 Mont. Code Ann. 1993; S.53-11-49 NM Stat. Ann 1991; S. 60 NY Bus. Corp. Law (1986); art 2.43 Texas Business Corporation Act Ann. 1993; S.13.1-335 of Va. Code Ann. (1993) and S.23A 08.490 Wash. Rev. Code 1993.

Company statutes of most states and the Model Business Corporation Act authorize shareholders to remove directors from office with or without cause at a meeting called specifically for that purpose by the votes of holders of a majority of the shares entitled to vote at an election of directors[78]. Under U.S. law a company may, therefore, adopt a by-law providing for the removal of a director with or without cause.

a) Right To Remove With Cause

Irrespective of a contrary provision in the statute, charter or by-laws, shareholders have the power to remove directors from office during their term if substantial grounds can be shown. This common law right is known as 'amotion' and may be exercised not-withstanding the existence of a contractual obligation. The right to remove for substantial cause cannot be excluded by a shareholders' agreement requiring the maintenance in office

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78. See for example S.39 of the Model Business Corporation Act 1971; S.10.06 455 Alaska Stat. (1989); S.10-039 Ariz. Rev. Stat. Ann. (1990); S.303 Cal. Corp. Code (1990); S.706 NY Bus. Corp. Law (1986); S.16-10-37 Utah Code Ann. (1993); Also the California case Elevator Operators and Starters Union, Local 117, of San Francisco v. Newman, 30 Cal. 2d 799, 186 P 2d I which held that even the entire board of directors may be changed by a vote of the majority shareholders. S.304 Cal. Corp. Code gives the superior court of the county, where the principal office is located, the power to remove any director in the case of fraudulent or dishonest acts or gross abuse of authority, on an application of shareholders holding at least ten percent of the outstanding shares with or without voting rights. Once removed such directors may be barred from election for a period prescribed by the court. See Starbird v. Lane, 203 Cal. App. 2d 247, 21 Cal. Rptr. 280.

of a particular director designated by a shareholder[79].

There are case law authorities to show that neither shareholders nor directors have the power to remove directors or officers before the expiration of their term, except for cause, if the term of office is fixed by the charter or by a general statute. In Wolf v. Gegen-Seittige Unterstuetzungs Gesellschaft Germania[80], the Wisconsin court stated that every company has at common law, as incident to its existence, the power of removing directors, but that this power can be exercised only for cause and after notice and hearing. In the New York case of Grace v. Grace Institute,[81] the court emphasized that a company possesses the power to remove a director or officer for cause before the end of his term regardless of the existence of a provision in the Charter or by-laws providing for non- removal.[82]

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79. In Springut v. Don & Bob Restaurants of America, Inc., 57 A.D. 2d 302, 394 NYS 2d 971 (1977), a director contested his removal for cause on the basis of a shareholders' agreement which gave certain shareholders the right to elect or re-elect their nominees. The court held that the director could be removed for cause despite the agreement. The court clearly stated that implicit in any agreement to maintain a director in office is the director's duty to fulfil the requirements of his office. Also the Pennsylvania case of Visor v. Waters, 320 Pa 406, 182 A 241.

80. 149 Wis. 576, 136 NW 175

81. 19 NY 2d 307, 279 NYS 2d 721, 226 NE 2d 531

82. Also the Texas case of Textile, Inc. v. Wineburgh, 373 SW 2d 325; the Florida case Frank v. Anthony, 107 SO 2d 136 (Fla.); and the New York case of People v. Powell, 201 NY 194, 94 NE 634.

b) Ground For Removal

Statutes, charter provisions and by-laws can sometimes limit the right of shareholders to remove directors to certain grounds. Where the grounds for removal are expressly designated then the main question will be whether the facts bring the case within the provision and whether there is sufficient ground for purposes of removal.[83] Statute may stipulate various causes that can warrant removal and these have included conviction for a felony, a declaration that a director is of unsound mind by a court order,[84] a declaration that a director is bankrupt or unable to perform duties for six months by reason of illness.[85]

Removal may also be justified where a director assumes a managerial or executive position with a competing enterprise.[86] Furthermore, an officer with a fixed term contract may be removed for breach of contract by undertaking

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83. Section 306 Cal. Corp. Code 1990; Ch. 32 para 8.35 Ill Rev. Stat. Ann. 1993; S.707(6) Me. Rev. Stat. Ann. tit 13-A 1981; S.706(d) NY Business Corporation Law 1986; S.55.27(g) NC Gen. Stat. 1990; S.7-1.1-36.1(d) R1 Gen. Law 1992.

84. Section 302 Cal. Corp. Code 1990; S.55-27(b) NC Gen. Stat. 1990 and S.1701.58(B) Ohio Rev. Code Ann. 1986.

85. Section 12.18C(2) La. Rev. Stat. Ann. 1969.

86. Eckhaus v. Ma, 635 F Supp. 873.

unauthorized acts, misapplication of funds, or incompetence[87]. Mere failure to attend directors meetings for several months does not, however, constitute sufficient ground for removal and a director's absence from a state thus failing to attend some of the meetings does not warrant removal from the board[88].

c) Right To Remove Without Cause

The common law prohibition against removal without cause is, however, no longer applicable in jurisdictions with modern company statutes[89]. These statutes accept the view that since shareholders are the "owners" of the company, they should have the power to change the directorate at will. In New York and Rhode Island removal without cause is authorized only if the articles of incorporation or by-laws so provide[90].

Tennessee law generally allows for removal with or without cause but if a director is elected by a group of shareholders only that group may participate

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87. In Miller v. Ortman, 124 Ind. App. 290, NE 390, the Indiana appeal court held that since the conduct of the company's fiscal affair by the president was such that endangered the company's stability, there was sufficient grounds to remove him.

88. Alliance Co-op. Ins. Co., v. Gasche, 93 Kan. 147, 142 P 882.

89. Examples are Section 8089(a) Rev. Model Business Corporation Act 1984, Section 303 Cal. Corp. Code 1990 and Section 141(K) Del. Code Ann. tit 8 1991

90. Section 706 NY Business Corporation Law 1986 and Ss.7-1.1-36.1(a)-(c) R.1. Gen. Law 1992.

in a vote to remove the director without cause[91]. Texas allows the articles of incorporation to provide for removal of directors without cause, subject to restrictions contained in the by-laws[92].

When shareholders are given the power to remove directors without cause, their motive for exercising that power is irrelevant[93]. If an officer is removed without cause, although his or her authority to represent the company ceases, the company will be liable to the officer for breach of contract. In Heller v. Clark Merchandisers,[94] the court reiterated this point when it held that an officer deposed by majority votes of the directors had the right to damages for breach of contract.[95]

d) Jurisdiction Of The Court To Remove Directors Or Officers

Although the general rule is that the power to remove corporate directors and officers is in the company, an exception to this general rule has been made where fraud or misappropriation is alleged. It is a well-established position, under American law, that the courts have the power to remove

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91. Section 48-18-108 Tenn. Code Ann. 1988.

92. Section 16-10-37 Tex. Business Corporation Act Ann. 1993.

93. Section .8. 4B Rev. Model Business Corporation Act 1984

94. 9 Misc. 2d 106, 154 NYS 2d 150

95. Also Stott v. Stott Realty Co., 246 Mich. 267, 224 NW 623

trustees for substantial cause, such as misappropriation, long continued absence, antagonism of interest and other grounds. Directors have no personal interest in their office but may be compared with trustees, who are subject to removal by the courts - as fiduciaries directors are sometimes referred to as trustees.

In some states statutes have been adopted authorizing the removal of directors by the courts for sufficient cause either at the suit of the corporation or a shareholder acting on its behalf, or at the suit of a certain number of shareholders designated by statute.[96] In a few jurisdictions statute permits an action to be brought to remove a director for cause either by the attorney general or by holders of ten percent of the outstanding shares, whether or not they are entitled to vote[97]. The Revised Model Business Corporation Act, and a few other jurisdictions that have adopted the provision of that Act, permit holders of ten percent of outstanding shares to institute a court action to remove a director for certain conduct involving fraud, or gross abuse of authority[98].

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96. Section 304 Cal. Corp. Code 1990, S.55-27(g) NC Gen. Stat. 1990; S.706 NY Business Corporation Law 1986; S.1726(c) Pa. Stat. Ann. tit 15, 1993.

97. Examples are S.706(d) NY Business Corporation Law 1986 and S.7-1.1-36(d) R.I. Gen. Laws 1992. In People v. Lyon, 119 App. Div. 361, 194 NYS 319, referring to S.706(d) the court ruled that the New York statute authorizes an action against one or more trustees, directors, managers or other officers of a company to procure a judgment removing such a person from office upon proof of a conviction of misconduct.

98. Section 8.09 Ark. Code Ann. 1991; S.79-4-8.09 Miss. Code Ann. 1989; S.48-18-109 Tenn. Code Ann. 1988

To this effect the California statute provides that a court

> " may, at the suit of shareholders holding at least 10 percent of the number of outstanding shares of any class, remove from office any director in case of fraudulent or dishonest acts or gross abuse of authority or discretion....[99]

American courts have, therefore, given recognition to the fact that the law is opposed to directors or officers continuing in office after having been guilty of wrong-doing or against whom exists a prima facie case of malfeasance in office[100]. Ross v. 311 North Central Avenue Building Corp.[101] involved a class action brought by minority shareholders against a company and its directors for fraudulent loans, the Appeal Court held that when the trial court found that the acts of the directors were fraudulent and oppressive, it rightly removed them from management of the company.

D) APPOINTMENT AND REMOVAL OF DIRECTORS UNDER GERMAN LAW

1. INTRODUCTION

In order to understand the processes of appointing and removing corporate

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99. Section 304 Cal. Corp. Code (West 1990)

100. The New Jersey case of Shuster v. Vetnor Gardens, Inc., 103 NJ Eq 93, 141 A 457

101. 130 Ill. App. 2d 336, 264 NE 2d 406 (1970)

directors under German law it is important to point out that there are two main types of incorporation available to businesses under that law – these are the Stock Corporation (AG) and the Limited Liability Company (GmbH).

Traditionally the GmbH has a unitary board structure unless the shareholders provide in the articles for a two-tier structure but this traditional structure can be modified with respect to companies to which one of four Co-Determination Acts applies. The creation of a supervisory board is optional for the shareholders in a GmbH but mandatory if it is required by a Co-Determination Act. The AG, on the other hand, is required to have a two-tier board system consisting of a management board and a supervisory board.

2. The Stock Corporation (AG)

a) Appointment Of The Supervisory Board Members

The founders of a company have the duty of appointing the first supervisory Board members. To this effect Section 30(1)[102] provides :

> "The incorporators shall appoint the first supervisory board of the company ....Such appointments shall be made in the form of a notarial deed."

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102. Section 30(1) AktG 1965

The initial board members are to hold office until the end of the first general meeting of shareholders. The first supervisory board is generally not subject to any applicable co-determination law. Subsequently the members of the supervisory board that are to represent the shareholders are elected by the general meeting,[103] unless certain shareholders are entitled to appoint a specified number of members to the board. Such right, as given to shareholders, to appoint a certain number of board members may be granted by the article to the holders of registered shares of the company.[104]

For companies that are subject to the Shop Constitution Act 1952, the Act Supplementing the Coal and Steel Co-Determination 1956 and the Co-Determination Act 1976, employee representatives are elected by the employees[105]. Employee representatives and neutral members of supervisory boards of companies that are subject to the Iron and Steel Co-Determination Act are elected by the general meeting but the meeting is regulated by the provisions of the Works Council[106].

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103. Section 101(1) Akt G 1965

104. Section 101(2) Akt G 1995

105. Section 76 Betr VG 1952; Ss.6 and 7 Montan Mit Best Erg G 1956; and S.9 Mit Best G 1976

106. Section 6 Montan Mit Best G. 1976

Where the supervisory board does not have the number of members necessary to constitute a quorum the court may appoint the required members to the board[107]. If there has been a vacancy on the board for three months but the existing members still constitute a quorum, the court, on application, will appoint additional members. In emergency situations the court need not wait for the expiration of three months.[108] In all such cases, the application to the court for the appointment can be made by the management board, any supervisory board member, a shareholder, an employee organisation or by a certain number of employees[109].

b) Removal Of Members Of The Supervisory Board

Any member of the Supervisory Board may be removed prior to the expiration of his term of office either without cause or with important justifications.

i) Removal Without Cause

Supervisory Board members that are elected by the general meeting may be removed by a three-quarters majority resolution of the general meeting[110]

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107. Section 104 Akt G 1965

108. Section 104(2) Akt G 1965

109. Sections 104(1) Nos 3 and 4, 104(2) No 3 Akt G 1965

110. Section 103(1) Akt G 1965

although the articles may provide for a different majority and stipulate additional requirements. Members that were appointed to the board by individual shareholders may be removed or replaced by those shareholders who had the right to appoint them and failing that the general meeting may effect the removal. Section 103(2) which provides for this states:

> "If the requirements specified in the articles in respect of the right to appoint are no longer met, the shareholders' meeting can remove those delegated members by a simple majority of votes."[111]

The members that were elected by the employees in accordance with the provisions of the Shop Constitution Act 1952 may be removed by a resolution passed by a three quarters majority of the employees' votes[112]. The other Co-Determination Acts also contain provisions on the removal of supervisory board members appointed thereunder as employee representatives[113].

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111. Section 103(2) Akt G 1965

112. To this effect S.76(5) of the Works Constitution Act 1952 (Betr VG 1952) states "the appointment of an employee representative to membership of the Supervisory Board may be revoked before completion of the term at the request of the works council or by at least one fifth of the employees in the establishment of the enterprise. The resolution requires a majority comprising at least three quarter of the votes cast".

113. Section 11 of The Coal and Steel Co-Determination Act 1951 (Montan Mitbest G BGB1 195); S.10 of The Supplemental Co-Determination Act 1956 (Montan Mitbest Eng. G BGB1 1956); and Section 23 of The Co-Determination Act 1976 (Mitbest G BGB1 1976

ii) Removal For Important Cause

Any member of the supervisory board may be removed by the local court (Amtsgericht) of the company's domicile if an important reason is given, irrespective of who appointed the member or pursuant to which law he had been appointed[114]. If a supervisory board member who has been delegated to the board by shareholders is to be removed in this manner, in addition to the supervisory board resolution, holders of ten percent of the stated capital or those holding shares with an aggregate par value of DM 2 million or more may make the application. Any removal effected by the court is required to be justified by an "important reason" such as the members' inability to fulfil his duties, a serious breach of obligations, or unlawful disclosure of business secrets.[115]

c) Appointment Of The Management Board Members

Members of the management board are normally appointed by the supervisory board of the company[116]. Each member may be appointed for a

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114. Section 103(3) AktG 1965.

115. Ibid

116. Section 84 AktG 1965; In urgent situations the court, at the request of the company, can appoint a member who is known as a Notvorstand to fill a vacancy on the board – Section 85 AktG 1965.

term not exceeding five years with an extension or a re-appointment being permissible as long as the extension is effected at least one year before the expiration of the initial term[117]. The supervisory board has the discretion to decide how long to extend the appointment of a management board member for and cannot be forced to re-appoint a member beyond a term of five years.

The procedure for the appointment of the management board members depends on which Co-Determination law applies. In companies that are not subject to co-determination such appointments are made by a simple majority resolution of the supervisory board[118]. In companies that are subject to the Co-Determination Act of 1976, the appointment of a management board member generally requires a supervisory board resolution passed by two-thirds majority of all the members. Where this majority cannot be achieved, a committee provided for in the Co-Determination Act[119] must propose a candidate.

d) Removal Of The Management Board Members

The appointment of members of the management board can be terminated by

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117. Section 84(1) Akt G 1965

118. Sections 84 and 108 Akt G 1965

119. Section 27(3) Mitbest G 1976

a resolution of the supervisory board and only if an important cause exists[120]. A member of the management board who has been removed can challenge his removal by taking the matter to the court [121].

3. The Limited Liability Company (GmbH)

a) The Supervisory Board

The creation of a supervisory board in the German Limited Liability Company (GmbH) is either optional or mandatory. It is mandatory if it is required by The Coal and Steel Co-Determination Act 1951, The Supplementary Coal and Steel Co- Determination Act 1956, the Co-Determination Act 1976, the Shop Constitution Act 1952 or if the company is a capital investment company[122]. While the Co-determination Acts regulate, in details, the election of the employee representatives on the supervisory board they leave the appointment of the shareholder representatives to the shareholders. Where

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120 Section 84(3) Akt G 1965; "Important cause" has been defined in the Act as including gross violations of duty or inability to manage the company properly. An important cause is also deemed to exist if the general meeting has resolved that a member of the management is no longer trustworthy, unless the resolution was clearly adopted for arbitrary reasons.

121. The Panel for Commercial Matters of the Regional Court at the company's domicile has jurisdiction over such matters.

122. Capital investment companies are also subject to more complex rules on accounting standards, auditing and disclosure.

the optional supervisory board is concerned the Limited Liability Company Act (GmbHG) contains references to a number of provisions of the Stock Corporation Act[123].

i) The Optional Supervisory Board

The optional supervisory board is normally created on the basis of the provisions of the articles. A company's articles may either establish the supervisory board directly or authorise the shareholders to establish one by a resolution of the general meeting. Although members of this board are generally required to be appointed by a simple majority resolution of the shareholders, the articles may require a greater majority. Any member may, at any time with or without cause, be removed from this board by a three-quarter majority shareholder resolution[124].

ii) The Mandatory Supervisory Board

When the establishment of a supervisory board for a GmbH is mandatory the rules governing such supervisory boards are found in the applicable

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123. Section 52(1) GmbHG which states "If pursuant to the articles of association a supervisory board shall be constituted, then S.90(3), (4) sentences 1 and 2; S.95 sentence 1; S.100(1) and (2) No 2; S.101(1) sentence 1, S.103(1) sentences 1 and 2; Sections 105, 110 to 114, 116 of The Stock Corporation Act in connection with S.93(1) and (2) and Ss. 170, 171 and 377 of The Stock Corporation Act shall apply accordingly unless the articles of association determine otherwise.

124. Section 52(1) GmbH and Section 103(1) AktG.

Co-determination Act where they are set out in part directly and in part by reference to provisions of the Stock Corporation Act. Those provisions concerning mandatory supervisory boards take precedence over conflicting provisions of the GmbH Act, the articles of the company and shareholder resolutions. The appointment and removal of members of the mandatory board are, therefore, regulated by the same provisions as regulate the appointment and removal of the supervisory boards of stock companies

b) The Management Board Of The Limited Liability Company (GmbH)

The GmbHG requires every limited liability company to have one or more managing directors to manage the affairs of the company and to represent it in and out of court[125]. The appointment of the managing directors to the board is a corporate act which is governed by company law. It must be distinguished from the service agreements of such managing directors which are governed by the law of contract.

i) Appointment Of The Managing Directors

The managing directors are appointed by a simple majority resolution of the

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125. Sections 6(1) and 35(1) GmbHG.

shareholders unless the articles provide otherwise or a Co-determination Act requires that the managing directors be appointed by the supervisory board. A company's articles may, however, provide that the appointment of the managing directors by shareholders' resolution be subject to a greater majority[126]. The supervisory board has the exclusive right to appoint the managing directors if the company is required to have a supervisory board by the Coal and Steel Co-Determination Act, the Supplementary Coal and Steel CO-Determination Act or the Co-Determination Act[127].

If a company is subject to parity co-determination under the Coal and Steel Co-Determination Act, the Supplementary Coal and Steel Co-Determination Act or near-parity co-determination under the Co-Determination Act then at least one of its managing directors is required to be a labour director[128]. Such a labour managing director is to be appointed by the supervisory board and a resolution to appoint a labour director cannot be passed if a majority of the labour representatives on the supervisory board votes against it[129].

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126. Section 45(2) GmbHG

127. Section 12 Montanmitbest G 1951; S.13 Montanmitbest EngG 1956 and S.31 Mitbest G 1976 which are in each case connected to S.85 AktG.

128. Section 13 MontanmitbestG 1951; S.13 MontanmitbestEngG 1956 and S.33 MitbestG 1976.

129. Section 13(1) MontanmitbestG 1951

ii) Removal Of The Managing Directors

Any managing director of a limited liability company may be removed from his office by a shareholder resolution passed by a simple majority vote[130] unless the articles provide otherwise or a co-determination law assigns the authority to the supervisory board. The articles may, however, increase the majority required for a shareholder resolution which removes a managing director from the board. The supervisory board is given the power to remove managing directors where a limited liability company is required to have a supervisory board under a Co-Determination Act.[131] A company's articles can restrict the right of shareholders to remove managing directors without cause but cannot restrict rights to remove them for cause[132].

E) CONCLUSION

In the Anglo-American system, the statutory and regulatory framework paint a picture of shareholders having the power to hire and fire directors which seems to run contrary to the powers given to directors to co-opt members on

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130. Sections 46(5) and 47(1) GmbHG

131. Section 12 MontanmitbestG 1951, S.13(1) MontanmitbestEngG 1956 and S.37 MitbestG which are each in connection with S.84(3) AktG 1965.

132. Section 38(2) GmbHG ; The articles, for instance, could provide that a managing director cannot be recalled during a specified term of his office except for important cause.

to the board. The reality is that in the U.K. and U.S. management picks the slate of candidates with shareholders playing very little (if any) role in the nomination and appointment processes. To this effect the electoral process has not been an effective mechanism for assuring shareholder control over their board of directors[133].

One of the most important weapons of shareholder control under U. K. law - the power to remove a director - is supposed to be one which can be called into play regardless of any term in a director's contract. Shareholders may, however be intimidated by the compensation payable to a director for the loss of earnings. Apart from this there is the practical problem of procedural restriction which can act as serious deterrent to shareholders who want to remove directors. This leaves corporate managers in a position of exercising managerial powers with no viable mechanism by which shareholders can hold management accountable for its decisions.

The position under German law is in no way better in that the rights of German employees as embodied in the Co-determination Laws enable employees to be represented on supervisory boards and on workers'

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133. Korn/ Ferry International, Board of Directors, Twentieth Annual Study 1993; Also a 1992 ProNed Survey found that 86% of directors were dissatisfied with the approach adopted by companies in appointing non-executive directors.

councils. Employee rights under German law constitute an attenuation of shareholders' right to determine the composition of the board[134]. When compared with U.K. and U.S. positions where employee involvement in corporate decision-making is discretionary German shareholders are at a disadvantage, in this respect, in comparison with their Anglo-Saxon counterparts.

An important difference between U.K. law and those of U.S. and Germany is the statutory right given to the court under U.S. and German laws to remove directors for substantial cause. By giving minority shareholders[135] the right to petition the court for purposes of removing directors, the laws of these two systems have made shareholders' right to remove directors much more meaningful.

In the U.K. there is no judicial power to remove directors on the basis of dishonesty or inability to perform their duties. Although shareholders have the power to remove directors by a majority vote in the U.K., that power may not be a practical remedy for shareholders who wish to use it. With the requirement that a minority can institute proceedings to remove a director

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134. The possibility that membership of the supervisory board may be divided equally between employee and shareholder representatives may have serious implications on the ability of shareholders to exercise control over the management of their companies.

135. In both U.S. and Germany the requirement is that holders of 10 percent of the share capital can file a suit asking the court to remove certain directors.

for substantial cause in the U.S. and Germany, shareholders have a better chance of effecting changes to their board composition.

CHAPTER FIVE

BOARD STRUCTURE AND SHAREHOLDER REPRESENTATION ON CORPORATE BOARDS

A) INTRODUCTION

The traditional corporate structure conceives a board's roles as those of management and accountability. With the emergence of large public companies it has become clear that the board of directors is unable to play these roles that has been entrusted to it by the legal model.[2] This realisation has resulted in the recognition of a functional division within a company's board between management and supervision.

The board of directors is the principal management authority with the responsibility of ensuring that the goals of the company are fulfilled[1]. The board's relationship with its management team is, however, governed by the rules and regulations of a country's corporate law and practice with variations leading to differences in the effectiveness of the board as an overseer of management, regardless of the ownership structure.

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1. Charkham, J., Keeping Good Company, 1995, 272, Oxford Press

2. Ezzamel and Watson have argued that criticisms of boards accountability to shareholders have resulted in measures for improvement being seen as a necessity for purposes of protecting shareholders interests. - Ezzamel, M. and Watson, R, Wearing Two Hats: The Conflicting Control And Management Roles of Non-Executive Directors, in Keasey, Thompson and Wright, Corporate Governance, 1997, 75, Oxford University Press

This new board model posits a supervisory team with the role of monitoring management's business decisions on behalf of shareholders. As it becomes increasingly apparent that the supervisory group is neither properly equipped nor in a position to perform their monitoring role effectively the search for remedies has intensified.[3]

Under the Anglo-American corporate practice, although members of the board are appointable by the shareholders, with the diffused nature of share-holding rarely does any individual shareholder cast enough votes to secure active representation on the board. The primary controlling element on the board is supposed to be the existence of non-executive directors. Under the German two-tier board structure the management board manages the company on a day-to-day basis reporting regularly to the supervisory board. On its part, the supervisory board appoints and dismisses members of the management board·[4]

One major sector of corporate affairs that has resisted the European Community harmonisation efforts has been the area dealing with board structure and powers of the different types of directors in the company. Board

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3. Short, H. Non-Executive Directors, Corporate Governance and the Cadbury Report: A Review of the Issues and Evidence, Corporate Governance, 4/2 (1996) 123, 129-31; see also Hart, O., Corporate Governance: Some Theory and Implications (1995) 105 Economic Journal 678, 681-4

4. Chapter two of this work deals with the main functions of the two arms of the German two-tier board.

structure was, however, one of the main subjects of the proposed Fifth Directive[5] which has not been adopted to date.

This chapter analyses the different ways that corporate boards are structured in the U.K., Germany and the U.S., and identifies the categories of persons that serve on those boards. It explores the question of how far the idea of placing worker directors on corporate boards would affect the powers of shareholders to remove directors that they are dissatisfied with and replace them with others more suited for those positions. It examines the proposed Fifth Directive and its various amendments in the light of the Commission's proposals on co-determination and discusses how the proposed changes would affect board structure and corporate practice in the U.K. For the purpose of comparing the unitary and two-tier board structures the last part of this chapter examines the advantages and disadvantages of each type.

B) BOARD STRUCTURE IN THE UNITED KINGDOM

Until the mid 1960s there was very little active interest in the concept of worker directors in the U.K. The practice until then had been based on the tradition of collective bargaining between unions representing workers, management and the representatives of capital.

5.15 J.O. COMM EUR (NO. C131) 49, Oct. 13, 1972, as amended in 1983, 26 O.J. EUR. COMM (NO. C240) 2, Aug. 19, 1983.

In presenting written evidence to the Donovon Commission in 1966 the Trade Union Congress (TUC) gave real impetus to the discussion on the prospects of appointing worker-directors to corporate boards.[11] The TUC. was in favour of a discretionary provision to allow companies to make provisions for trade union representatives on the board of directors.[12] To this effect they stated:

> " ....provision should be made at each level in the management structure for trade union representatives of the work people employed in these industries to participate in the formulation of policy and in the day to day operation of these industries." [13]

The bulk of the British steel industry was nationalised in 1967, under conditions which were not economically favourable. Associated with this nationalisation was a drive to improve efficiency and productivity. It was against this background that the British Steel Corporation (B.S.C.) launched its worker-director scheme. Brannen summarises the objectives thus:

> " First, (the scheme) would act as a symbol of a new departure in industrial elations in the newly nationalised industry. Secondly, worker directors would provide the board with new dimension in its discussions....Finally, the scheme should be seen as a part of a serious effort on the part of the corporation to involve its numerous employees in working out the future policies of the industry."[14]

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11. Royal Commission on Trade Unions and Employers Association (The Donovon Commission) 1965-68 Report, CMND 3623

12. Trade Unionism, (T.U.C., London 1966) para 290

13. Ibid para 262

14 Brannen P., Batstone E., Fatchett D., and White P., The Worker Directors: A Sociology of Participation, 1976, 96, Hutchinson, London.

Worker directors were eventually appointed to the nationalised British Steel Corporation in May 1968. The initial proposal, relating to the appointment of workers as part-time directors provided for up to three worker directors to be appointed to each of the four group boards for a period of three years.[15] The mechanics of the appointment of worker directors were of particular interest. First, the Steel Corporation, through the T.U.C., asked unions that were active in the industry to put forward nominations. Those nominations then went through a vetting process before twelve worker directors were finally appointed by the corporation[16]

1. The Input Of Committees On U.K. Board Structure

Despite the changes in the nationalised Steel industries little had happened by the early 1970's to indicate that U.K. was moving towards a worker director system. With Britain joining the E.C. on the 1st of January 1973, soon after the first draft of the Fifth Directive was published in 1972, renewed interest was stimulated in the area of employee representation. The main reason for the interest was that Britain, along with the other E.C. member states, would be placed under an obligation to implement board level employee representation if the Directive was passed as community law.

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15. Ibid at p. 134

16. Ibid at p. 98

a) The Bullock Committee's Recommendations On Board Structure

This renewed interest resulted in the setting up of a committee to enquire into the issue of industrial democracy.[17] This committee had a term of reference which stated:

> " Accepting the need for a radical extension of industrial democracy in the control of companies by means of representation on the board of directors, and accepting the essential role of trade union organisations in this process, to consider how such an extension can be achieved, taking into account in particular the proposals of the Trade Union Congress Report on industrial democracy as well as experience in Britain, the E.E.C. and other countries. Having regard to the interests of the national economy, employees, investors and consumers, to analyse the implications of such representation for the efficient management of companies and for company law."[18]

The Committee undertook an extensive review of the different alternatives of board structures. Faced with the task of deciding whether employee directors should sit on unitary boards or on supervisory boards under a two-tier structure, the majority report expressed a preference for the former model thus rejecting the introduction of a two-tier system[19]

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17. Inquiry On Industrial Democracy Committee, First Report, Cmd. 6706 (1977) (Bullock Report)

18. O.R. (House of Commons) 5 August, 1975, col. 245.

19. Supra note 12 at para 8.15

b) Cadbury Committee's Recommendations On Board Structure

In the U.K. there is a distinction between the categories of directors on the unitary board - namely non-executive directors and executive directors. The board has the power to appoint one or more of the full-time directors to serve as managing directors.[20] In practice it is the managing directors, rather than the board who manage the company. The board on its part supervises management and makes general policy decisions. U. K. boards are often made up of a majority of executive directors, the very group which the board is required to monitor.[21] To reduce this problem the Cadbury Report suggests an increased role for non-executive directors. The Report encourages every listed company to have at least three non-executive directors whose

> " calibre...... should be such that their views will carry significant weight in the board's decision."[22]

The rationale for this reliance on non-executive directors is based on the belief that they are of independent status and bring to bear on the company's problems a wide cross-section of opinion and experience. Being independent

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20. Art. 84 Table A of the Companies Act 1985

21. Byrd, J.W. and Hickman, K.A, So Outside Directors Monitor Managers? , (1992) 32 Journal of Financial Economics 195, 198-200

22. See The Report of the Committee On The Financial Aspects Of Corporate Governance (Cadbury's Report) 1992, para. 4.11, Gee & Co.

of management non-executive directors should be free from any business and other relationships which could interfere with the exercise of their independent judgement.[23] The Report, however, fails to resolve the conflicting roles of non-executive directors. In this regard the Cadbury Report has done little or nothing to improve the independence or incentives for non-executive directors to take their monitoring role seriously.

The Report also recommends that there be a separation of functions between the chairman of the board and the chief executive director[24] with the purpose of preventing one individual from having unfettered powers. To this effect the Report states:

> " Chairmen should be able to stand sufficiently back from the day-to-day running of the business to ensure that the boards are in full control of the companys' affairs and alert to their obligations to their shareholders."[25]

It is interesting to know that the past few years have seen encouraging signs of compliance with these recommendations by U.K. companies.[26]

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23. See para 4.12

24. See para 4.9

25. Ibid

26. The report on a study undertaken by the accountancy firm Arthur Anderson in conjunction with Director Magazine in the New Law Journal, 15 Oct. 1993, 1434 at 1435 - states that the Cadbury's recommendations on ways of preventing abuse of boardroom powers are beginning to take effect; Cohen N. cites examples of moves by U.K. companies to separate the positions of chairman and chief executive director. BAT Industries have asked the chairmen/chief executive directors 'to take off one of their hats' in compliance with Cadbury's recommendations – Cohen N, Of Hats and Heads, Fin. Times, 5 Feb 1993 p. 10; see also Preston R, Chairman of Spring Ram Urged To Quit By Shareholder, Fin. Times , 10 July 1993 p. 24;

All the recommendations of the Cadbury Report are, however, made in the context of preserving a unitary board structure with the emphasis being placed on internal governance and monitoring within the one-tier board. Very little attempt is made at employee participation in corporate decision-making. Directors are simply instructed by statute to have regard to the interest of the employees in managing the affairs of the company which is enforceable only as a duty owed to the company.[27]

c) The Hampel Committee's Recommendations On Board Structure

The Hampel Committee, which was established in November 1995, was a continuation of the effort to put in place a process of reform in the area of corporate control.[28] Its main purpose was to examine the role of directors, shareholders and auditors, and to promote high standards of corporate governance in listed companies.[29] Although the Hampel report largely repeats and approves the Cadbury recommendations it made a few additions in the area of board structure. It recommends that the board should disclose which non-executive directors are considered to be independent.[30] The Hampel Report also recommends that non-executive directors should make up at

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27. Section 309 Company Act 1985

28. The Committee On Corporate Governance, Final Report, (Hampel's Report) (London: Gee & Co., January 1998)

29. Hampel's remit extended only to listed companies.

30. Recommendation 9.

least one-third of the board of directors[31]. It states that companies should identify a senior non-executive director to whom concerns can be conveyed[32] and that all board members be subject to three yearly re-election.[33] It commends as best practice the use of nomination committees for purposes of ensuring that the nomination process is not dominated by the executives.[34]

The setting up of these committees is a clear indication of the reliance on self-regulation based on non-legal Codes of Best Practice. Despite the broad consultative processes undertaken and the carefully thought out Codes of these different committees, the core problems on board structure still remain. It is still envisaged that non-executive directors should combine their monitoring role with management functions. It has to be recognised that to remain co-team members with the very group that they are to monitor can restrict the effectiveness of non-executive in performing their monitoring role.[35]

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31. Recommendation 12; The Cadbury report did not indicate any proportion but simply stated that they should be 'of sufficient calibre and number'.

32. Recommendation 15

33. Recommendation 17.

34. Recommendation 16; The Cadbury Report had merely endorsed their use.

35. Ezzamel, M. and Watson, R., Wearing Two Hats: the Conflicting Control And Management Role of Non-Executive Directors, in Keasey, Thompson and Wright (eds), Corporate Governance: Economic Management and Financial Issues 1997, 64, Oxford University Press

The committees have not addressed the problem of availability of relevant and adequate information for non-executives to perform their important roles. While the Cadbury Report has not touched on this area at all, the Hampel Report states that

> " management has an obligation to provide the board with appropriate and timely information and the chairman has a particular responsibility to ensure that all directors are properly briefed."[36]

Even with the input of the Hampel report much discretion is still left in the hands of the group that is to be monitored. Emphasis has been placed on the issue of non-executive independence from the executive directors. Hampel's Report goes so far as requiring that the board should assess and report on directors' independence. There has, however, been no attempts by these committees to specify the criteria for determining this independence.

2. The Effect That Worker Representation Would Have On U. K. Law

A scheme of worker directors in the British context would require the compulsory appointment of a certain number of employee representatives to the boards of companies. It also would amount to certain fundamental changes in the nature of British company law and in the way the boards traditionally operate. At present worker influence in corporate decision-making is expressed primarily through joint regulation by representatives

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36. Recommendation 6 of the Hampel Report

of employees and management as enshrined in the institution of collective bargaining, which is confined to the traditional issues of wages and hours of work[37].

The decisions accorded by the Companies Acts exclusively to shareholders include many that the employees would expect representation on the board to give them joint control over (for instance major constitutional changes and corporate re-arrangements). Another area of concern would relate to the position of the board of directors who constitute the policy-making body of the company and upon which it is proposed that employees should be represented.

English company law simply requires that all public companies registered after 1910 must have at least two directors while private companies are required to have at least one.[38] For the rest, matters are largely left to be settled by individual company's articles of association. Since the articles are under the control of shareholders in general meeting it would become necessary to modify this position if the board, through employee representation, ceases to be representative only of the shareholder interest. For employee representation to be implemented it would seem that the broad

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37 McCarthy W.E.J. and Ellis N.D., Management By Agreement (1973), p.103; Gordon, Business Leadership In The Large Corporation (1966) pp. 53-55

38. Section 176 Companies Act 1948 which is now Section 285 Companies Act 1985

parameter of directors powers which is left to the optional articles would need to be prescribed by legislation.

C) THE PROPOSED FIFTH DIRECTIVE

1. The 1972 Draft

The first draft of the Fifth Directive in 1972 had two major subjects of controversy which were the two-tier board structure and the representation of employees in the supervisory councils of companies with 500 or more employees.[39] The ratio was to be one to two whereby for every two supervisory board members named by the shareholders, one member would be named by the national works council. It proposed that employee representatives be labour union officials who themselves were not employees.[40]

Under the first draft, as far as board structure and employee participation were concerned, the requirements were that:

a) all public limited companies, regardless of their size, should have a compulsory two-tier board structure comprising of a management board responsible for managing the company's affairs and representing the

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39. Art.4., 15 J.O. Comm. EUR. (No. C 131) 49 (Oct 13, 1972)

40. Lang, The Fifth EEC Directive On The Harmonization Of Company Law, 1975, 12 COMM MKT. L. REV 155

company in negotiating contracts and a supervisory board which was to supervise and control the management board.[41]

b) the supervisory board was to elect the management board for a fixed period which could not exceed six years.[42]

c) members of the supervisory board could not simultaneously be members of the management board[43]

d) the supervisory board was to give ultimate approval on decisions made by the management board in a specified number of fundamental corporate matters.[44]

e) the supervisory board was to approve all contracts to which the company was a party if any supervisory or management board member had an interest, direct or indirect, in the contract.[45]

This initial draft provided that member states would have to adopt one of the following methods of employee participation:

a) Participation in the appointment of members of the supervisory board;

b) Participation through employee representation on the supervisory board or administrative board;

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41. OJC 131, 12.12.72, arts 1& 2

42. Ibid art. 3(1)

43. Ibid art 6

44. Ibid Art 12, the list in Article 12 could, however, be extended by State law

45. Ibid art 10(1)

c) Participation through a body composed solely of employee representatives;

d) Participation through collective bargaining corresponding to the principles of one of the previous models. In response to this draft the European Parliament proposed a tripartite membership for the supervisory board, consisting equally of representatives of owners, employees and independent individuals. The latter were described as persons representing general interests, possessing relevant expertise and not dependent on the owners or employee organisations.[46]

2. Towards A More Flexible Fifth Directive: The Revised Draft Of 1983

The proposals of this initial draft aroused vigorous controversies and the Commission, being aware of the need for a more flexible approach which would take account of the economic, social and legal developments existing in each member state, asked the Economic and Social Committee for its opinion.[47] This committee, although in favour of the dual board system and employee representation on the board, proposed that member states should be allowed to keep their single board system.

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46. Schwartz D. (ed), Commentaries On Corporate Structure And Governance 1979 p. 48

47. The Economic And Social Committee is a consultative body comprising of representation of employer, employee and other interests. Members of this committee are appointed for a four-year renewable term - EEC Treaty Arts 193, 194 & 195

In 1982 the European parliament developed some alternatives and in 1983 the Commission put forward a revised proposal for a Fifth Directive designed to appease its critics while achieving the principal objectives of the original proposal.[48] With respect to the supervision of corporate managers the amended Draft Fifth Directive offered a choice between the original two-tier structure and a one-tier in which a majority of the members would be non-executives[49]. It raised the threshold from 500 to 1,000 employees with respect to the participation of employees in the supervision of large companies.[50]

The 1983 proposal stated that for all public companies a distinction should be made between directors responsible for supervision on the one hand and management on the other. This is to be achieved in one of two ways:

a) A one tier board with the executive directors managing and the non-executive directors supervising.

b) A two-tier board structure consisting of a supervisory and management board. The management board having the sole power of day-to-day management. The main role of the supervisory board being to appoint members of the management board and to monitor their actions.

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48. See the amended proposal for a Fifth Directive 26 O. J. EUR. COMM. (No. C 240) 2 (Aug. 19, 1983)

49. Ibid arts. 2(1), 3(1) & 21a (1)

50. Ibid arts. 4(1) & 21b

The proposal also required every public company with 1,000 or more employees (including employees of subsidiaries) within the European Community to install a system of employee participation. Three options were made available:

1. Board representation for employee by way of electing between one third and one half of the supervisory board members or alternatively co-option by the supervisory board subject to control by the general meeting or employees' representatives.
2. A works council (which should represent all employees entitled to regular information and consultation).
3. A collective agreement (with one or more trade unions) effectively giving the same rights as in one or other of the previous two options to members of those trade unions.

To some extent boards of U.K. listed companies are already moving towards the direction of the first board structure proposed by the 1983 draft which requires a one-tier board with executive directors managing and non-executives supervising. This has been evidenced by the establishment of audit committees of non-executive directors to whom the auditors report matters of concern in the company's draft account. There are also moves to establish committees of non-executives for purposes of remuneration and nomination.

D) GERMAN BOARD STRUCTURE AND EMPLOYEE PARTICIPATION

1. A Brief History Of The German Two-Tier Board System

Germany is a classic example of a system with two arms of corporate management and has always been referred to as the land of industrial democracy[51]. The management/supervisory board structure of German boards is not a recent development. The practice can be traced back to an old system in Germany where major enterprises were organised as limited partnerships with shares. During the second half of the last century the practice arose in these limited partnerships of setting up a small committee of persons to represent the limited partners and to act as a supervisory body over the activities of the unlimited partners. It was originally introduced by the German Commercial Code of 1861 and was made compulsory in 1870.[52]

The underlying aim was to ensure that the function of controlling management, which was formerly exercised by the state, was undertaken by shareholders. Although under German law supervision of corporate management by non-managers dates back to 1870, the practice of consultation with employees on German industrial matters had been put in

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51. Davies P. and Wedderburn, The Land Of Industrial Democracy, (1977), Industrial Law Journal 197

52. Vagts, D., Reforming the Modern Corporation: Perspective from the German, 80 Harv. L. Rev. 23, 50-51.

place long before then, what was new in the system was actual representation of employees in the decision-making organ of a company. This practice eventually spread to companies and German company law came to require a supervisory board in all public companies and some private companies which were large enough to be caught by the co-determination laws.

2. The Limited Liability Company (GmbH)

Traditionally the German limited liability company (GmbH) consists of the managing directors and the shareholders unless the shareholders provide in the articles for a supervisory board to oversee the managing directors without engaging in management activities. This traditional structure has been modified with respect to those companies to which the co-determination laws apply. Thus the creation of a supervisory board is either optional or mandatory for limited liability companies. It is optional for companies that are not subject to any of the co-determination laws, with the option being given to shareholders to provide for it in the articles. It is mandatory for limited liability companies which are subject to any one of the co-determination laws.

Where the optional supervisory board is concerned the shareholders are free to deviate from the statutory regime and shape a supervisory board that is more suitable to their special interests and needs. Where the establishment of a supervisory board is mandatory by virtue of a co-determination law, the rules governing its structure will be those in the applicable Co-determination Act. The different Codetermination Acts are:

____ The Coal and Steel Co-Determination Act of 21st May 1951 (MontanmitbestG) which is applicable to certain companies in the industries of mining, coal and steel production and requires eleven members on the supervisory board[53]

____ The Supplementary Coal and Steel Co-Determination Act of 7 August 1956 (MontanmitbestErgG) which is applicable to certain holding companies that own enterprises in the industries of mining and coal and steel production and which creates what is known as parity co-determination.

____ The Co-Determination Act of 4th May, 1976 (MitbestG) which is applicable to enterprises with certain types of legal structures, including GmbH, that employ more than 2000 individuals and which create a near parity co-determination.[54]

____ The Shop Constitution Act of 11th October 1952 (BetrVG) which is applicable to enterprises with certain legal structures including the GmbH, that employ more than 500 individuals and which creates 'one-third' co-determination.[55]

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53. Section 4 MontanMitbestG 1951

54. Sections 1 & 7 MitbestG 1976

55. Section 76(1) BetrVG1952

As the degree of co-determination that is required depends on the Co-determination Law that is applied changes to the traditional structure of the GmbH vary depending on the applicable Co-determination Act.

3. The Stock Corporation (AG)

The German stock corporation is characterized by the strict separation of the management board from the supervisory board. The management board bears responsibility for managing corporate activities while the supervisory board has the duty to appoint, supervise and remove members of the management board. The composition of the supervisory board of the AG will depend on whether and which co-determination law applies. The following are the different co-determination laws that can determine the composition of the supervisory board:

a) The Coal and Steel Co-Determination Act 1951

This enactment provides for workers in the steel, iron and coal industries to elect five of eleven members of each company's supervisory board[56]. The five employee representatives on the board exercise a voice equal to the five shareholder representatives which results in a system of

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56. Gruson & Meilicke, The New Co-Determination Law In Germany, 1977, 32 BUS. LAW 571, 572

parity co-determination. This element of parity was further preserved by requiring all ten board members to select the chairman[57]. Under this Act the supervisory board is also responsible for appointing a three-member management board which in turn is responsible for running the company on a day-to-day basis and addressing specific problems. Worker-participation on the supervisory board tends to be restricted to the policy-making level and does not lead to participation on the technical managing boards[58].

b) The Co-Determination Law 1976

The 1976 Co-Determination Law greatly expands the number of business entities that are subject to the principle of parity co-determination. The provisions of this law now apply to most legal entities, including joint stock companies (AG), limited liability companies and partnerships limited by shares[59]. Excluded from the effect of its provisions are entities already regulated by other co-determination laws[60] as well as political, charitable and news media organisations[61]. For a company to come within the regulation of

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57. Vorbrugg, Labor Participation In German Companies And Its European Context, 1977, 11 INT'L LAW, 249, 255

58. Comment, Co-Determination in West Germany, 1971, 51 OR. L. REV. 214, 215-16

59. Section 1(1) Co-Determination Law 1976

60 Such as the coal and steel industries that still are subject to the 1951 Act.

61. Section 1(4) Co-Determination Law 1976

this law it must employ more than 2,000 employees[62]. Every company that is subject to this law is required to create a supervisory board, if it does not already have one[63]. Such a supervisory board is to have an equal number of shareholder and employee members[64].

The 1976 Law clearly specifies the size of the supervisory board based on a sliding scale according to the number of employees, and also specifies the proportion of union and other employees entitled to sit on each supervisory board[65]. Office staff and clerical workers are entitled to vote for a number of electors proportionate to their representation in the total work force[66]. The electors in turn vote for the supervisory board members. These arrangements suggest a legislative purpose of preventing production worker from dominating the employee seats. Requiring proportional representation obviously prevents the more numerous production workers from blocking the election of any representatives from the clerical and administrative minority. The Co-Determination Law thus recognises that different groups of employees constitute separate interest groups according to their work classification.

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62. Section 1(1)

63. Section 6(1) .

64. Section 7(1)

65. Section 7(1) & (2). It provides that the supervisory board with six to eight employee members should have two union members. This law does not, however, interfere with the internal procedures by which such union members are selected.

66. Section 11(2)

A striking contrast to the Anglo-American position is the Co-Determination Law's treatment of managerial employees by defining and treating senior managers as part of the office worker rank[67]. The Co-Determination Act also authorises the supervisory board to appoint one labour director who is to be a member of the company's supervisory board. Once appointed the official is regarded as a member of the enterprise's management, similar to a Vorstand member.

The law requires that all the responsibilities of labour and social activities be concentrated in the duties of the labour director and that such responsibilities may not be diluted by delegating them to any other official of the company.[68] The labour director also exercises powers and performs such duties as are prescribed by the Co-Determination law as well as those provided by other laws.[69] As is in the case of the managing directors appointed to the management board, divesting shareholders of the right to appoint this important member of the supervisory board constitutes a significant appropriation of shareholders' powers in German companies. This constitutes one of the key differences between German shareholders' rights to determine the composition of their boards and those of their Anglo-American counterparts.

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67. Section 3 (3) (1)

68. See Hoffmann D, The German Co-Determination Act 1976 at 34 (1976).

69. Such as the Labor Management Relations Act of 1972, BGBl 1 13 (1972)

c) The Works Council Act 1972

First enacted in 1952 the Works Council Act provides for co-determination at the shop level, as opposed to the corporate boardroom.[70] The 1972 Act also applies to small enterprises not subject to the 1976 Co-Determination Law. The Works Council Act has a very wide scope. Any enterprise employing five or more workers shall elect a works council with at least three of the employees being eligible to act as electors[71]. This Act requires works councils to co-operate with employers for the welfare of "the employees and the enterprise[72]

The role of works councils is, however, not limited to that of soliciting and facilitating employee suggestions but they are also granted a specific, but limited, role of resolving policy issues and disputes. Members of the works council are also responsible for facilitating employees' efforts to exercise various rights that are granted to them under the Works Council Act. Among these rights are the right to inspect one's personal file,[73] the right to lodge

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70. This law substantially amends and extends the Works Council Act 1952

71. Section 1 Works Council Act 1972; Ss 7-9 specify the eligibility rules for election to a work council.

72. Section 2(1)

73. Section 3 Works Council Act 1972

complains[74] and the right to demand explanations on how the employees are remunerated.[75]

With regard to companies that are not subject to any co-determination law, the Stock Corporation Act will apply. The number of supervisory board members stipulated by the Stock Corporation Act depends on the amount of stated capital. The requirement under this Act is that for companies with a stated capital:

- of up to DM 3,000,000.00 : nine members
- exceeding DM 3,000,000.00 : fifteen members
- exceeding DM 20,000,000.00 : twenty-one members.

The German supervisory board is, therefore, the controlling body and the management board is required to report regularly to it. Although parity representation between the shareholders and the employees is required in large companies in practice the chairman, who has a veto power, is normally from the shareholders' side and is almost always a bank representative. Despite the supervisory board's right to appoint and dismiss members of the Vorstand, outright dismissals are rare. Members of the Vorstand who no longer enjoy the confidence of the Aufsichtsrat often resign and may stand for re-election after five years.

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74. S.84

75. S. 82 (2)

E) BOARD STRUCTURE IN THE UNITED STATES

As in the U.K., U.S. boards of directors have, in the main, the duty of making the major business decisions and defining the general policy while leaving the execution and the day to day operations to the officers. Thus, in theory, there is a clear distinction between directors and officers with the usual officers being the president as the chief executive officer, the vice president(s), the secretary and the cashier[76].

1. Attitude Towards Codetermination

For a long time there was no worker participation at enterprise level in U.S. companies. The unions rejected any such role for they viewed their function as one of confrontation with management through collective bargaining, and any participation in management would have been inconsistent with that function. The general attitude of Americans towards the issue of worker-director was well worded by Ellenberger when he stated:

> " He (the American worker) is smart enough to know, in his bones, that salvation lies - not in reshuffling the chairs in the board room or the executive suite - but in the growing strength and bargaining power of his own autonomous union." [77]

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76. Vagts, D. F, Basic Corporation Law, 3th ed, 1989, 298, Foundation Press Inc.

77. Ellenberger, The Realities of Co-Determination AFL - CIO Federationist, 15 Oct. 1977, 25

In this regard the European idea of codetermination initially had a cold reception in the U.S. Apart from this general attitude, a variety of legal provisions impeded companies from adopting co-determination. Companies Codes provide for the election of directors only by shareholders[78] and bondholders.[79] It is also noteworthy that effective co-determination requires reasonably strong employee organisations to whom the employee board members are answerable, and with a co-operative relationship between the managers and the employees. A good relationship between employer and employee, in that system, would require changes in legal rules and attitude.[80]

One of the most obvious contrasts between American law and that of Germany is the right of workers to information concerning the enterprise. Section 106 BetrVG requires that the employer should keep the employee representatives informed " in time and thoroughly" concerning a wide range of matters including the economic and financial situation of the enterprise. This enables the representatives to make informed decisions on behalf of the workers. In the U.S., unions are not entitled to such information. Employee

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78. Section 36 of the Model Business Corp. Act (1979); This exclusive right of shareholders could, however, be side-stepped by a provision in the charter under the " otherwise provided " clause of S. 35 of the Act.

79. Section 221, General Corporation Law, Del. Code Ann tit 8 (1974)

80. Summers C.W, Worker Participation In The U.S. and West Germany: A Comparative Study From An American Perspective, 1980, 28 AM. J. COMP LAW, 381-2,

participation, which should be a means of avoiding confrontational situations between managers and workers, was, therefore, not given the same emphasis in the U.S

Although American company law does not expressly provide for a supervisory body within the corporate structure as it exists in Germany, in practice the functional position of the outside directors[81] amounts to a somewhat similar institution. The main difference is that ' outside directors' do participate in the management of the enterprise by approving the acts of the executive directors[82]. This structure of management has been quite flexible in practice. The trend presently is to find what is called " inside boards" where most or even all the directors are executive directors of the company or of affiliated companies.

Though some large companies have "inside boards" that consist only of executives, yet most boards are mixed, with inside or full-time and outside or part-time directors. At the state level, beyond the obligation to appoint directors, state statutes normally have no mandatory provisions regulating board structure[83]. As far as federal laws are concerned, only the Investment

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81. These are members of the board of directors who are not officers.

82. The New York Stock Exchange, however, requires that listed companies have a minimum of two directors independent of management - S. 303, New York Stock Exchange, Listed Company Manual.

83. The vast majority of American states' statutes still require that every company has a board of directors although different statutes differ with respect to the minimum number of directors - see H. Henn and J. Alexander, Laws of Corporations 741-42, Little Brown & Co.

Company Act of 1940 as amended in 1970 and 1982 expressly require that every investment company should have a board of directors of which at least 40% of whom are to be disinterested in the sense of not serving other interest in the management of the company[84].

2. The Contributions Of the Courts

Despite this lack of uniform compulsory requirements the courts in their rulings have promoted the idea of independent board supervision[85]. The courts, in particular, have contributed to the American board structure in a rather unusual way by according high regard to the business judgment of outside board members[86]. Such regard is seen in the presumption that outside directors act reasonably and in good faith in making decisions on the company's behalf. In Kamin v. American Express Co.[87] the directors of

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84. Section 10(a) Investment Company Act, 15 U.S.C. 80a - 10(a) 1982

85. Dent, The Revolution In Corporate Governance, The Monitoring Board, And The Director's Duty of Care, 1981, 61 B.U.L.REV 623, 629-81 discusses the concept of an independent monitoring board and assesses the concept in light of legislative proposals.

86. The business judgement rule is a presumption that directors, in performing their functions, are honest and well-meaning and the their decisions are informed and rationally undertaken. - Solomon, L.D. and Palmiter, A.R., Corporations, 1994, 132, Little Brown.

87. 383, N.Y.S. 2d 807 (Sup. Ct 1976)

American Express faced the choice of liquidating a bad stock investment or distributing the stock to the shareholders as a special dividend which would have resulted in additional tax liability for the shareholders. The board opted for the distribution of dividend despite shareholders' protests. The directors explained to the court their concern that liquidation might have had an adverse effect on the company's net income figure and the court found the concern sufficient. In Graham v. Allis Chalmers Manufacturing Co.[88] the court refused to hold the directors liable for not instituting antitrust compliance.[89]

Institutions and associations have had considerable influence over board structure in the U.S. The New York Stock Exchange requires that newly listed firms should have at least two independent board members[90]. The most outstanding contributions on the issue of board structure has been made by the American Law Institute (ALI) Corporate Governance project.

3. The American Law Institute's (ALI's) Contribution To Board Structure

The ALI's Principles of Corporate Governance (PCG)[91] advocate a board

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88. 188 A. 2d 125 (Del. 1963)

89. Also Shlensky v. Wrigley, 237 N.E. 2d 776 (Ill. App. 1968)

90. New York Stock Exchange, Inc, Company Manual, 1988, 29

91. ALI Principles of Corporate Governance: Analysis and Recommendations 83-84 (Tent. Draft No.2 1984)

monitoring scheme for the oversight of managers of "publicly held corporations"[92] This scheme envisages a division of functions between the senior executives of the company who are in charge of the day-to-day management and the company's board of directors whose task is to monitor and control the executives.[93] This division of functions between the executives and the board is supported by a number of other provisions designed to refashion the board so that it can perform its monitoring role more effectively. The PCG requires that all large public companies with no controlling shareholder should have independent non-executive directors as the majority on the board and at least three for all other public companies.[94]

Other provisions designed to enhance the monitoring role of the board include Section 3A.04 which recommends a nomination committee for all public companies to be composed entirely of non-executive directors, a majority of whom should be independent. Section 3.05 requires the adoption of audit committees by large public companies. Section 3A.02 recommends the adoption of compensation committees by large companies to advise on directors' and senior executives' remuneration. These committees are to

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92. A publicly held corporation is defined by Section 1.31 as a corporation with 500 or more record holders of equity securities and at least $5m of assets

93. Sections 3.01 and 3.02 of the ALI's Corporate Governance Recommendations.

94. A large public company has been defined in Section 1.24 as a corporation with 2,000 or more record holders of its securities and at least $100m of assets

be composed of non-executive directors, a majority of whom are to be independent. Sections 3.03 and 3.04 require that all directors be given rights to corporate information and advice from their own experts at the expense of the company.

Comparing these provisions with the corresponding ones in the Cadbury's Report it becomes clear that although Cadbury also emphasizes the monitoring role of the board and also advocates reforms to boardcomposition, its provisions do not carry the same force as those of the PCG. It does not specify any minimum number of non-executive directors[95] and fails to formally recommend a nomination committee.[96]

One of the main purposes of independent outsiders on the board is the loosening of internal corporate power structure by creating an intermediate supervision of corporate management within the unitary board system. The lameness of outside directors in fulfilling this role is illustrated by their inability to monitor and oversee the actions of the executives. Given the domination of the internal election processes by management it is not surprising that managers select outside directors who

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95. Paras. 4.8 and 4.9 simply enumerate the qualities of non-executive directors and recommend that they should form a majority.

96. Para 4.30 discusses the merits of nomination committees without making any recommendation.

are sympathetic to their views and are unlikely to challenge them in their positions.[97]

In such situation supervisors are chosen by the good graces of those to be supervised and therefore feel personally indebted to and dependent upon them[98]. This is obviously the case for outside directors who are unlikely to depart, at a board meeting, from the inside line determined by management. Milgrom and Roberts have indicated that non-executive directors

> " rely on the executives for most of the information they receive , and they need relationships with the officers if they are to function well in guiding corporate policy. Often, directors share similar backgrounds and interests with the firms executives. "[99]

Moreover they often occupy interlocking directorates, and merely change their respective roles as executive and non - executive directors.[100]

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97. A common phrase used in describing this situation is that management prefer to choose directors who do not " rock the boat". Green H. S, Why Directors Can't Protect The Shareholders, FORTUNE, 17th Sept. 1984 at 28.

98. Herman, E., Corporate Control, Corporate Power, 1981, 31 - indicates that directors serving on the board at the chief executives request will have a sense of loyalty to him with personal ties also being present.

99. Milgrom, P., and Roberts, J., Economics, Organization and Management, 434, Englewood Cliff, N J Prentice Hall

100. Senate Subcommittee On Reports, Accounting And Management Of The Committee On Governmental Affairs, "Interlocking Directorates Among The Major U.S. Corporations " S. Doc. No. 107, 95th Cong., 2nd Sess.1 (1972). The implication is that the managers of one company oversee the managers of another – Cowan A.L., Board Room Back Scratching, New York Times, June 2, 1993, D1 – where it was stated that five pairs of companies had their executives sitting on each others compensation committee.

4. Moves Which Favour Emlpoyee Representation On U.S. Corporate Boards

Since the mid 1980s there has been a tremendous amount of attention in the U.S. focused on various measures by which workers can be drawn into the decision-making and production processes of their companies. The continental view that corporate management should consider the interests of other constituencies in the system, thus, appears to have now attained some credence in the United States. The reason for this interest in the participatory role of workers is based on the present notion that participatory work arrangements bring about dual gain. By allowing workers participation in production decisions that affect their daily work life, it is believed that working can be made more meaningful and satisfying to the workers. The other arm of the dual gain lies in the potential for improvement in production because to ignore workers' input is to overlook a vast reservoir of potential improvements in the business industry.

A number of Delaware decisions have expanded the business judgment rule to allow corporate directors to take into account the impact of their decision-making on other corporate 'stakeholder' groups especially employees and creditors. In Unocal Corp. v. Mesa Petroleum Co.,[101] the court suggested that

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101. 493 A. 2d 946, 955 (Del. 1985)

the business judgment rule allows directors to consider, among other factors, the effect of takeovers on creditors, employees, customers and even the community generally when implementing defensive measures[102]. Twenty-eight states in the U.S. have now passed " other constituency" statutes permitting, though usually not requiring, senior managers and corporate directors to consider the interests of other stakeholders[103]. Although there is evidence that workers do desire some input into actual strategic corporate decisions-making[104] such participation will involve decisions in areas that have historically been regarded as management's domain. Reiterating this

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102. In Revlon, Inc V. MacAndrews & Forbes Holdings, Inc, 506 A 2d 173, 182 (Del. 1986) the court stated that the board may give regard to other various constituencies of the company when discharging its responsibility

103. The Minnesota statute is typical in this regard. It reads:

> " In discharging the duties of the position of director, a director may, in considering the best interests of the corporation, consider the interests of the corporation's employees, customers, suppliers, creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation."

MINN. STAT. ANN. S. 302A. 251(5) (West Supp. 1993). Other Statutes include those of Connecticut, Iowa, Indiana, Pennsylvania and Georgia - Hansen, C. Other Constituency Statutes : A Search For Perspective, 46 Bus. Law. 1355, at 1355 (1991).

104. Kochan T.A, Katz H.C. and Mower N.R, Worker Participation And American Unions : Threat or Opportunity ? Kalamazo, Michigan : W.E. John Institute for Employment Research , 1984, 108 - 112.

point Howard Samuel, President of the AFL - CIO Industrial Union Department, has stated :

> " What is needed is a much more deep - seated change in labour-management relationships , in which workers through their unions are kept informed of major decisions affecting production and employment, and they have the means of influencing those decisions to protect the best interests of workers and the company. "[105]

There has been greater emphasis on providing a more humane working environment in which employees achieve greater job satisfaction. The Chrysler Corporation which was in great financial distress, asked the President of the United Auto Workers, to serve on its board of directors which he did.[106] Since then the Chrysler union has voted for the practice of union participation on the board to be continued.[107] Other industries have since negotiated for worker participation on their company boards although so far it has been limited to companies in severe financial distress. In the airline industry, at least six airlines have worker representation on their boards of directors as a result of the collective bargaining process.[108]

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105. " Worklife " Plans Given Mixed Review, AFL - CIO News (January 28 , 1984).

106. 116 LAB. REL. REP. (BNA) 92 (1984).

107. Ibid at 94 .

108. See Developments , Employee Ownership , December 1983 at p. 4

The most comprehensive arrangement for worker participation on a board of directors appears to be that of Eastern Airlines , one of the largest airlines in the U.S. The company was in severe financial difficulties having lost about 7.5 million dollars in 1982[109]. Because of this employees agreed to a one - year pay cut of approximately eighteen per cent in return for shares worth approximately twenty five per cent and the right to designate four members , one from each of the four major employee groups, for appointment to the company's nineteen -member board of directors.[110]

Other elements to this agreement include :

1/ Union Choice of Directors : Management agreed to support the unions nominations for directors, thereby making it clear that the choice of the represertatives was that of the unions and not of management.[111]

2/ Union Participation In Decisions : The agreement established a plan to allow the employee group to review, comment and make suggestions on issues regarding business plans and major capital expenditure[112] .

3/ Director Representing Non - Union Employees : One of the directors was

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109. Comment, Eastem Airlines, N.Y. Times ,December 9, 1983, at 1 col 4 .

110. The agreements are contained as appendixes to the Eastem Airlines , Inc, PROXY STATEMENT (April 24 , 1984) and are further summarised in the EASTERN AIR LINES INC.PROSPECTUS, (1984 Wage Investment Program).

111. 116 LAB. REL. REP. (BNA) 92 (1984).

112. EASTERN AIR LINES INC., PROXY STATEMENT (April 24 ,1984)

to be appointed by employees who are not represented by any union. This addresses the concern that employees who are not union members should also be given participatory rights.[113] In addition to improving the level of profitability, the agreement has clearly improved the work atmosphere at Eastern Air Lines[114].

The federal government is also encouraging worker participation programmes . On May 1, 1984, the President's Commission On Industrial Competitiveness (PCIC) issued recommendations emphasizing the need for greater labour - management co-operatoin and new collaborative efforts to maximise productivity through open communication and worker participation.[115]

F) UNITARY VERSUS TWO-TIER BOARD STRUCTURE

The question that has to be asked is how the German supervisory board compares with the Anglo-American non-executive/outside directors. In an attempt to answer this question this part of the work will compare the two board structures. A closer look at both the unitary and two-tier structures shows that each has its advantages and disadvantages. Under the U.K. and

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113. Summers, Codetermination In The United States: A Projection Of Problems and Potentials, (1982), 4 J. Comp. Corp. L & Sec. Reg. 155, 161

114. Comment, Eastern Airlines, Wall St. J. Oct 31, 1984 at 1 col.6

115. Industrial Competitiveness Commission Report, 116 Lab REL REP.(BNA) 36 (1984)

U.S. systems independent non-executive directors are supposed to perform functions similar to those of the German supervisory board. When compared with non-executive directors, the supervisory board offers an advantage in that the respective competences are clearly separated.

This very aspect of the two-tier structure can be criticized on the ground that the board is supposed to be a homogeneous group which should work harmoniously for the general good of the company. Like non-executive directors , the supervisory board members may not be acquainted with the details of the day-to-day business but as far as independent control is concerned, the supervisory board may be at an advantage.

Although the functions of non-executive/outside directors can be compared to those of the supervisory board, the representation of employees and trade unions on the supervisory boards of German companies may, however, have important implications on corporate control. While profits are of more importance to shareholders, employees attach more importance to job security. Output and employment growth may be in conflict with profit maximisation which is the main concern of shareholders. In view of the self-interest of corporate managers to acquire influence and reputation by expanding the operations of their company, their preference is likely to have a lot in common with the interest of employees. This is one of the reasons why it has been contended that the German system of codetermination encourages inside collusion between management and employees.[116]

Membership of the supervisory board is not determined by the Chief Executive Officer but consists, by law, of shareholder and employee representatives. No insider, including the Chief Executive Officer, can sit on the supervisory board let alone dominate it as in the Anglo-American system.[117] Much of the success attributed to German boards can probably be put down to the existence of institutional shareholders, who are also large creditors, motivated to protect their investments and loans to the company but the presence of employees on the same board may help to balance the conflict of interests that may arise.

Under U.K. and U.S. laws shareholders exhaust their powers as equity owners once they have voted in the election of directors - with the agency rules stepping in to make such directors agents of the company. The executive directors thereafter acquire powers delegated to them by the board. The powers exercised by the German management board, in contrast, is not

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116. Baums, T., The German Banking System and Its Impact on Corporate Finance and Governance, Universitat Osnabruck, Institut fur Handels-und Wirtschaftsrecht, Working Paper, No. 2/93 (1993) at 24

117. Roe, M., Some Differences In Corporate Structure In Germany, Japan and America, 1993, 102 Yale Law Journal, 106

delegated to it but rather conferred upon the board by statute. [118]

The supervisory board possesses the authority to compel the management board to submit reports on demand and can require that it obtains the supervisory board's approval before entering into certain transactions[119]. Board membership may provide major shareholders and creditors of German companies with regular access to the company's long term plans. Another striking features of the dual board structure is that it allows owners to interact regularly with management and to review, though informally, management's performance about four times a year[120].

With such flow of information shareholders may be able to minimise their investment risk and refrain from insisting on short-term objectives. The infrequency with which the supervisory board meets has, however, been viewed as one of the factors which makes the German model of internal corporate control ineffective. On average such meetings are four times

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118. Section 71 AktG 1965 - this section refers to the representation of the company. In this regard German law strictly distinguishes between representation and management. Representation has to do with external matters in which the powers of the Vorstand can be restricted.

119. For example a company's supervisory board may make the extension of credit above a certain level conditional upon the receipt of its prior approval - Baums, T., Corporate Governance In Germany: The Role Of The Banks, 1992, 40 AM. J. COMP. L. 503, 510

120. Roe, M. Some Differences In Corporate Structure In Germany, Japan and the United States, 1993, 102 Yale L. J. 1 at 18

a year and sometimes no more than the legal minimum of once every six months.[121] In such circumstances it becomes difficult to exercise any reasonable level of control over the company. This is a contrast to the frequent and often monthly meetings of the unitary board of the Anglo-American system.

Critics of the German two-tier system have also argued that the supervisory board has evolved into a closed shop, where all members work to perpetuate each other's power and perks[122]. Heinrich Weiss, President of the Federation of German Industries has described the atmosphere at supervisory board meetings succinctly when he stated:

> ".........the supervisory boards sometimes has no real control over the managing board. If you sit on the supervisory board of a large company and have labour representatives at the same table, you do not dare to put a critical question to members of the management board because you would be blaming them in the presence of the works councillors, when the managers need to keep their full authority....... it has come to be considered impolite for a member of the supervisory board to ask a question that is critical of management. This has led to a situation, especially in very large companies, where control over the management board has diminished to the point where management board members invite their friends and colleagues from other companies to join the supervisory board......."[123]

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121. Section 110(3) AktG 1965

122. Schneider-Lenne, E., Corporate Control In Germany, Oxford Review of Economic Ploicy, 1992, 8(3) at 120

123. Biney, G. (ed), Debunking the Myths About the German Company, (1993), Anglo- German Foundation Report in collaboration with the Royal Society for the Encouragement of Arts, Manufactures, and Commerce (London: RSA), 12

From all these the supervisory board appears to be far from perfect as a monitoring organ and is not too far from the unitary board of the Anglo-American system where the chief executive officers choose their own non-executives. Roe is of the opinion that a more suitable title should be 'advisory board' instead of 'supervisory board' as it exists merely to be consulted[124]. Despite this the two-tier board structure has some advantages over the Anglo-Saxon structure.

One obvious advantage of the German model of corporate control is the emphasis on the long-term interests of stakeholders. The disadvantage, however, is the rigidity that goes with it. Although long-term relationships with shareholders and the involvement of employees foster business stability, they discourage flexibility and make it difficult for German companies to change directions as quickly as their Anglo-American counterparts.

G) CONCLUSION

In all three systems corporate boards are charged with monitoring management on behalf of shareholders. In the Anglo-American system it has, at least, the nominal power to hire and fire the Chief Executive Officer,

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124. Roe, M., German Populism and the Large Public Corporation, (1994), 14 International Review of Law and Economics, 187 at 195; Also Prodhan, B., Corporate Governance and Long-Term Performance, (1993), Corporate Governance: An International Review, 172 at 176, criticises German supervisory boards as degenerating into a clique of men perpetuating each others powers and perks.

set his compensation and block any major corporate projects. The structure of the board is governed mainly by the rules and regulations of each country's corporate law and although there is a host of evidence on the weakness of boards in the U.S.,[125] there is less direct evidence of the effectiveness of boards in the U.K.[126]

By appointing non-executive directors to the board shareholders should be able to rely on this impartial group to closely monitor management. Despite the fact that board members in both systems are appointable by shareholders, with the diffused nature of shareownership rarely does any shareholder vote a large enough stake to get active representation on the board thus the board is effectively chosen by the Chief Executive Officer.[127]

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125. Jensen, M., The Eclipse of Public Corporation, Harvard Business Review, Sept 1989, 85; Weisbach, M. S, Outside Directors and CEO Turnover, Journal of Financial Economics, 431.

126. The Cadbury Report (1992) recommended a number of changes in the structure of boards of U.K. companies. One of their recommendations was a formal process for the selection of a number of independent non-executive directors to corporate boards.

127 Green H.S, Why Directors Can't Protect The Shareholders, Fortune, 17th Sept. 1984 at 28 - states that only those men and women who can get along with the chief executive are elected to the board; Also Prokesch S, America's Imperial Chief Executive, N.Y. Times Oct. 12, 1986, 25 posits that nominating committees are simply the arm and will of the chief executive, who feeds the names; Cadman J, Non-executive Directors: Are They Truly Independent? April 1995, S.J., 346 at 347 states that non-executive directors are not truly independent as their appointments are examples of the "jobs for the old boys" approach.

One of the main problems with the unitary board system is that supervision and monitoring roles become entangled with strategic decision-making and management roles of the board. The dual board structure, however, involves the legal recognition of two classes of directors having separate capacities, functions and powers[128] thus providing a more effective check on an overwhelming management than a group of non-executives on a unitary board.

The two-tier board system creates a clear separation of monitoring and management organs thus ensuring a distinct distribution of responsibilities and powers within the company[129]. The establishment of a dual board, therefore, represents a shift from the concept of shareholders being the ultimate owners of the company with the right to control its affairs. The German system, thus, attaches less importance to the ownership of a company and more emphasis is placed on the promotion of the commercial enterprise which includes all the groups involved in the company as a money making concern.

These important differences between the practices of these systems and the

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128. Many of American commentators are sceptical of the effectiveness of supervision by outside directors and do not believe that non-management directors make a significant difference - Borowski, Corporate Accountability: The Role Of The Independent Director, 9 J. Corp. Law 455 at 462 and 470- 71.

129. Karmel, The Independent Corporate Board: A Means To What End?, 1984, 52 Geo. Wash. L. Rev. 534 .

resulting effect on shareholders' rights moves one to question the enthusiasm of those who hail the relevant provisions of the Draft Fifth Directive as a move towards an effective pattern of corporate control in Europe. Although the two-tier management structure attempts to separate management from control this practice of separating management and control as seen under German law has been criticised on the basis that management should be a homogeneous group with no possibility of interference from outsiders.[130]

Notwithstanding the above criticism, it can, however, be argued that the differences between the management of these systems are not as much as would appear at first glance. Although the Anglo-American system has not established a special supervisory board, practice has often created a similar organ. The functions of non-executive/outside directors are comparable to those of the German supervisory board, though it should be kept in mind that even non-executive/outside directors still manage the company by approving management actions while such power is not enjoyed by the supervisory board. The two-tier system has an obvious appeal for the non-executive rank whose responsibilities would be greatly reduced where they no longer bear legal liability for the actions of their executive colleagues. Despite all these

130. Ackert, Shareholders And Management: A Comparative View On Some Corporate Problems In The United States And Germany, 46 Iowa L. Rev. 12-83, 23.

no serious considerations are being given to a change to the continental two-tier board system in the Anglo-American system.[131]

131. In the U.K. the various committees (Cadbury, Greenbury and Hampel) neither mentioned nor discussed this option and the American Law Institute (ALI) did not deliberate on this possibility either in its Corporate Governance Project.

CHAPTER SIX

THE PROXY VOTING MACHINERY

A) INTRODUCTION

The position at common law was that members of a company had to attend and vote personally at general meetings by a show of hands.[1] To enable absent shareholders vote at general meetings proxy voting was introduced. The meaning of the term 'proxy' depends on the context used as it may refer to the grant of authority to act on a shareholder's behalf or to the person holding the authority[2].

Proxy voting should enable shareholders to participate in the decision-making processes of their company even when they are absent from a meeting. This chapter examines the mechanism of the proxy voting system in order to determine whether it constitutes a meaningful way by which shareholders can exercise their voting rights.

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1. Harben v. Phillips (1883) 23 Ch. D. 14 (C.A.)

2. It is supposed to give shareholders who cannot attend general meetings the facility of authorising others to vote their shares to appoint and remove directors or approve transactions that require shareholders' approval. - Solomon L.D. and Palmiter, A.R., Corporations, 1994, 274, Little, Brown & Co. Proxy voting is, therefore, aimed at providing shareholders with the means of exercising their voting rights to effect changes when necessary.

B) PROXY VOTING UNDER UNITED KINGDOM LAW

Under U. K. statutory law, any member of a company entitled to attend and vote at a general meeting is entitled to appoint another person, whether a member or not, as his proxy to attend and vote on his behalf.[3] In the case of a private company a proxy also has the right to speak at the meeting.[4] Although the Jenkins Committee recommended that this right of proxies to speak at general meetings of private companies should be extended to public companies this recommendation has not been implemented.[5]

Unless the articles provide to the contrary, the provisions of Section 372 do not apply to a company which does not have a share capital nor may a member of a private company appoint more than one proxy to attend the same meeting.[6] Unless the articles so provide, a proxy can vote only on a poll and not by a show of hands. A member of a public company may appoint two or more proxies to vote in respect of different shares held by him, or may appoint two or more proxies in the alternative - so that if the first named proxy fails to attend and vote, the second one may do so.[7]

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3. Section 372 Companies Act 1985.

4. Section 372(1) Companies Act 1985

5. The Jenkins Committee Report Cmnd 1749 para. 463

6. Section 372(2)(a) and (b).

7. Section 372(1) and (2) Companies Act 1985.

Where proxy appointments are to be "in the usual form" a minor error as to the member's name or the shares held by him or as to any other matter, will not render the appointment invalid provided it does not mislead anyone as to the meeting at which the proxy is authorised to vote. In Oliver v. Dalgleish and Others,[8] proxies for use at an extraordinary general meeting of a company were given to T and some others to B. These proxies related to resolutions for the removal of two directors and for the election of two new directors in their stead. The proxies given to T misdescribed the meeting as the annual general meeting. Holding that a misprint on the face of a proxy did not entitle the company to reject it, Buckley J. stated that :

> " the mistake that was made here seems to me to be of so inoffensive a character and so unlikely to mislead anybody, or to have had any effect whatever on what the shareholders did, that I think the chairman was wrong on his ruling that these proxies were not properly to be admitted."[9]

The right to appoint proxies would be valueless if the board could require the documents appointing proxies to be lodged with the company a considerable time before the meeting is held. On this basis, the Companies Act 1985 invalidates any requirement in a company's articles that proxy appointments should be lodged, with the company or any other person, earlier than forty-

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8. [1963] 3 All ER 330

9. At p. 335

eight hours before the commencement of the meeting or an adjournment.[10]

1. The Contribution Of Case Law In The Development Of Proxy Voting

The courts have greatly contributed to the development of the law on proxy voting in the United Kingdom through the interpretation of statutory provisions and companies' articles. In Jackson and Others v. Hamlyn and Others[11] a company's meeting was not finished on the first meeting day so there was a motion and poll for the meeting to be adjourned for thirty days. If the vote went against the proposed adjournment, another meeting was to be held as soon as possible. The proposal to adjourn was defeated and the question to be considered by the court was whether the meeting to be convened in due course was a continuation of the original meeting or an adjournment, so that new proxies could be used at the resumed meeting if they were deposited forty-eight hours before the day of the resumed meeting. The court held that the resumed meeting which was held nine days after the original meeting of

10. Section 372(5) Companies Act 1985; The standard articles also require proxies to be filed 48 hours before the meeting. The Companies Act 1929 and earlier Acts contained no provisions with regard to proxies and articles of companies formed under those Acts often permitted the appointment of proxies but required their appointment to be lodged seven to ten days before the meeting. Unless such articles have been altered to conform to the Companies Act 1985, it would seem that lodgement in advance of the meeting cannot be required by the company since lodgement at an earlier or later time will render the proxy void.

11. [1953] 1 Ch. 57

January 29, 1953, was simply a continuation and not an adjournment and that no proxies deposited after January 18, 1953 would be valid as the articles required proxies to be deposited forty-eight hours before the meeting.

It is common for companies' articles to provide that a vote given by a proxy shall be effective notwithstanding the revocation of the authority, provided that the company has not received notice of the revocation.[12] Where the articles so specify such notice must be received before the meeting. Provisions to that effect are clearly effective as between the company and the members. In Spiller v. Mayo (Rhodesia) Development Company Limited[13] it was held that where the revocation has not been properly effected, the member has a right to attend and vote in person and the company has a duty to accept the member's votes in place of the proxy's.

In Cousins v. International Brick Company Limited,[14] one of the articles of a company provided that a vote given in accordance with the terms of an instrument of proxy will be valid notwithstanding the previous revocation of the proxy as long as the company has not received a written revocation before the meeting. The Court of Appeal held that where a proxy had not

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12. Article 63 of Table A 1985.

13. [1926] W.N. 78

14. [1931] 2 Ch. 90

been validly revoked, the shareholder who had given the proxy was free to attend the meeting and vote personally, Lord Hanworth observed that :

> "In the absence of clear words taking away the shareholder's personal right to vote....... the shareholder is able to attend and give his own vote according to his own volition and the proxy has no right to prevent it."[15]

An interesting question in relation to proxies is whether they are compelled to exercise the authority conferred upon them. Unless there is a binding contract or an equitable obligation compelling them to do so, the answer appears to be in the negative. Generally, there is only a gratuitous authorisation imposing no positive obligation on the agent, but merely a negative obligation not to vote contrary to the instructions of his principal if he votes at all. There may, however, be a binding contract if, for example, the proxy is to be remunerated. In addition there may be a fiduciary duty if, for instance, the proxy is the shareholder's professional adviser.

Although directors are not normally fiduciaries to individual shareholders, it appears that if they are appointed proxies and instructed how to vote they are required to obey those instructions. In Second Consolidated Trust v. Ceylon Amalgamated Estates,[16] in order to alter its debenture stock a company needed to pass an extraordinary resolution. At the general meeting convened for that purpose, the fourteen people present in person were unanimously in

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15. At p. 101

16. [1943] 2 All ER 567

favour of the resolution but did not constitute a quorum unless the proxies were counted. If a poll was demanded and the proxies used, the meeting would have been quorate but the resolution would not have been passed.

The chairman, aware of all the facts and acting bona fide, did not demand a poll so the resolution was passed by those present in person. The plaintiff shareholders contended that the meeting was not properly constituted, the proceedings were irregularly conducted and that the resolution was invalidly passed. It was held that the chairman was under a legal duty to demand a poll to give effect to the real sense of the meeting. Stating the position succinctly Uthwatt, J. emphasized that :

> "The duty of a chairman of a meeting is to ascertain the sense of the meeting upon a resolution properly coming before the meeting ..... I do not regard that as a personal right to be exercised according to the fancy of the chairman; in other words I do not think he has unlimited discretion as to the manner in which he may exercise that power."[17]

2. Solicitation Of Proxies Under U.K. Law

Directors are allowed to employ companies' funds in printing or sending out to shareholders proxy forms which are normally filled up with the names of the directors or their nominees as proxies and in stamping and posting the forms provided they honestly believe the expenses to be in the best interest

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17. At p. 569

of the company. In Peel v. London and North Western Railway Company, Buckley L.J. commented that :

> "the company may legitimately do and may defray out of its assets the reasonable expense of doing all such acts as are reasonably necessary for calling the meeting and obtaining the best expression of the corporation's views on the questions to be brought before it."[18]

Although the provisions on proxy voting and the case law authorities give an appearance of shareholder democracy and members being given the opportunity to participate in the decision-making processes of their companies, this appearance may be deceptive. The proxy voting machinery may actually help to strengthen directors' positions on the board thus putting them at an advantage over the shareholders. As Gower succinctly puts it:

> It cannot be said, that these provisions have done much to curtail the tactical advantages possessed by the directors. They still strike the first blow and their solicitation of proxy votes is likely to meet with substantial reponse before the opposition is able to get under way. Even if their proxies are in the 'two-way' form, many members will complete and logde them after hearing but one side of the case, and only the most intelligent or obstinate are likely to withstand the impact of the .... uncontradicted assertions of the directors."[19]

This leaves shareholders' power to determine the composition of their boards

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18. [1907] 1 Ch. 5 at p. 19

19. Gower L.C.B, Gower's Principles of Modem Company Law (6th Ed. By Paul L. Davies), 1997, 580.

a mere window dressing. According to Prentice and Holland:

> "This inherent powerlessness of shareholders has been exacerbated rather than reduced by the proxy voting system, at least as far as the United Kingdom is concerned, because proxies tend to be exercised pro-management and are granted before any shareholder meeting is actually held."[20]

Emphasizing the fact that management usually obtains a majority vote during shareholders' meetings, Maughan, J. gives a vivid description of the position thus :

> " ..... the dice are loaded in favour of the views of the directors : the notices and circulars are sent out at the cost of the company, the board has had plenty of time to prepare ..... If we contrast it with the position of a class of objectors, it is to be observed that a member of the class ..... has no funds with which to fight the case and he has no information ....."[21]

Even though the Stock Exchange requires that listed companies should send out "two-way" proxies to enable members to direct their proxies whether to vote for or against any resolution,[22] some members will complete and lodge the form before hearing the other side of the case. Only the very obstinate

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20. D D Prentice and P R Holland (eds), Contemporary Issues In Corporate Governance, 1993, 27, Clarendon Press.

21. Per Maughan, J. in Re Dorman Long and Company Limited [1934] Ch. 635 at 657-658

22. Yellow Book, Section 5, Chapter 2, para. 36. Table A of the 1985 Companies Act also includes two forms of proxy, one of which gives the proxy complete discretion (Art. 60) and the other, a two-way proxy which is to afford members an opportunity of instructing the proxy how it is to vote (Art. 61).

shareholders are likely to enquire into the assertions of the directors. In this sense U.K. does not have the sort of rules that regulate proxy voting in the U.S.

In 1975 Midgley, in a study to assess the use of proxies at general meetings, had observed that even if a reply card is provided to shareholders for the purpose of proxy votiing very few actually respond by appointing proxies[23]. Prentice states that there is no evidence that much has changed since then[24]. Even where a few shareholders seek to obtain proxies from other shareholders to oust incumbent management they may run into problems since indifferent shareholders are unlikely to withdraw their proxies after hearing the arguments of the opposition.

As a result proxy fights are rare in the U.K. as few shareholders bother to turn up and vote, or even sign the proxy forms assigning voting power to another shareholder or other duly appointed proxies[25]. This leaves the board of directors free to approve its own slate of directors.

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23. Midgley, Companies and Their Shareholders – The Uneasy Relationship. 1975, 52

24. Prentice D.D., Aspects of Corporate Governance Debate, in Prentice and Holland (eds), Contemporary Issues in Corporate Governance, 1993, 41, Clarendon Press,

25. Charkham J, Keeping Good Companies, 1995, Oxford University Press 294 – where he states that few shareholders bother to complete their proxy cards.

In theory, an opposition group can make use of the company's facilities to communicate its own views or to oppose the board, but the reality is that this does not generally affect management position in any way. The fact that management may not provide shareholders with the relevant information on the proposals that would be voted on at an annual general meeting may make shareholders' voting powers illusory.[26] Management selects nominees for appointment to the board and makes recommendations concerning them. The board of directors, therefore, gets its own policies and personnel voted through without having to worry about adverse shareholder reaction.

C) PROXY VOTING UNDER GERMAN LAW

Although German law allows registered shares, most shares in German public companies are in bearer form, and are deposited with banks. Such shares give banks the right to exercise the votes attached to the shares as proxies, without having to identify themselves as shareholders. The result is that proxy voting gives German banks enormous influence over corporate

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26. This position must have moved Smith to hold the view that despite the greatly increased financial reporting regulation, the reporting systems are not used by the board to inform shareholders – see Smith, T. Accounting For Growth, 1992, 8-17, London: Century Business; See also Sheridan, T and Kendall N, Corporate Governance, An Action Plan For Profitability and Business Success, 1992, 178 Pitman – where they state that with the existing regulation of the financial reporting system audit committees of U. K. companies should have no excuse for abdicting from their jobs.

decision-making. This voting power exerciseable through their positions as proxies enables the banks to vote the shares on behalf of the members concerned without identifying the shareholder.[27] Banks normally appropriate the function of voting by proxy to themselves by including a blanket authorisation in every deposit agreement facilitating their appointment as proxies by depositors.

German law recognises this practice of depository voting by providing that a person who has been authorised by a shareholder to exercise voting rights in his own name in respect of shares which are not held by him, shall specify the amount and class of such shares.[28]

1. Proxy Voting By German Banks

Although individual shareholders are generally not interested in attending and voting at general meetings, a high proportion of their total voting power will be represented at such meetings. The banks as custodians of deposited shares are usually notified of proposed general meetings.

Professor Baums has succinctly described the voting power of German bank thus :

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27. Section 136(4) AktG, 1965 BGB1 1118 (W.Germ)

28. Section 129(3) AktG, 1965

> "All banks together on average represented more than four-fifths (82.67%) of all votes which were present in company meetings. With one exception, they always had at least a majority of votes present. Consequently, they were able to elect the members of the supervisory boards (so far as these are elected by the shareholders, and not the employees)."[29]

Banks are required to request from their clients instructions on how to vote and should advise shareholders that they will exercise their voting rights in accordance with the instruction.[30] In the absence of a contrary instruction a bank will exercise the proxy in the way indicated on the form. This is known as deposit share voting right (DSVR).[31] To vote depository shares at a general meeting banks have to follow a rather complicated procedure. They have to submit to the shareholders specific proposals of how they intend to exercise the shareholders' voting rights at a particular meeting.

Where no specific instructions have been given by the shareholders, banks are permitted to vote in accordance with their own proposals.[32] In exceptional cases, however, a bank may deviate from the instructions received or from its own proposals, if it appears from the circumstances that the shareholders

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29. Baums T, Corporate Governance In Germany. The Role Of The Banks, 40 Am. J. Comp. L. 503 at 507

30. Section 128(3), AktG 1965

31. Section 135(6), AktG 1965

32. Section 135 para. 5, AktG 1965

would approve of the deviation. Shareholders have to be informed of such deviations and the reasons for them.[33]

The main question at this point is, whether German banks actually use their proxy votes to influence management decisions. In large German companies shareholders appoint up to one half of the supervisory board members depending on the size of the company, the rest being appointable by the employees. The supervisory board in turn appoints the management board and approves major corporate decisions while the management board handles day-to-day decisions.[34] Banks use their votes to elect nominees to the supervisory boards and in most cases a bank nominee chairs the board. Commenting on the process by which German banks acquire influence over corporate decision-making Roe states :

> "Typically, individual investors deposit the stock they own with their bank, and unless the owner gives the bank special instructions, the bank votes the custodial shares. ....German bankers use their votes to elect bank nominees to the supervisory boards of ninety-six of the one hundred largest German firms and in fourteen cases, a banker chairs the supervisory board. Although no single bank generally controls an industrial firm, together the three German large banks can, if they act in unison, dominate the shareholders' side of the supervisory board."[35]

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33. Section 135 para. 8 AktG 1965

34. Chapter five of this work has highlighted the German two-tier board structure.

35. Roe M.J, Some Differences In Corporate Structure In Germany, Japan, and The United States, 1993, 102 Yale Law Journal, 1927 at 1938-39; Also Baums T, Banks And Corporate Control, 1991, 29-30, Berkerly Law And Economics Working Paper No. 91-1

2. Problems Faced By Banks In Their Role As Proxies

The exercise of proxy votes by banks places them in a unique position to influence the outcome of shareholders meetings. Given small shareholders' inactivity, the banks as proxy holders enjoy high voting rights without a corresponding investment or risk and their readiness to represent small shareholders could also affect individual shareholder activism.

The second problem is the issue of conflict of interests. In most instances banks are far from being disinterested representatives of the shareholders. Due to the multiple role of German banks their interests and expectations might be in direct conflict with those of the company's shareholders. Such banks could exercise members' votes in a way that will safeguard their personal interests and maintain their status. Their votes are, therefore, very important on issues of corporate control and if they support management, banks which are supposed to vote in the interest of shareholders could, on the contrary, stifle shareholder activity[36].

Banks' decisions on investment may be influenced by the desire to prevent the company from withdrawing its deposit. They may vote for a new issue of shares more in the hope of earning fees as underwriters than in the interest of the company. Banks' interest in having a secured debtor may influence

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36. Chapter three of this work dicusses this problem of institutional investors

their votes for accumulation of profit against the distribution of dividends to shareholders. These multiple roles played by German banks bring into question the extent to which banks can truly represent the interest of shareholders in general meeting when determining the composition of the supervisory board. [37] As a result of this potential conflict of interests German banks, as depository institutions with power to influence the decision-making processes in companies, have experienced increasing criticism.[38]

3. Moves To Limit Bank Powers Over The Proxy Machinery

The powers of German banks have attracted public, media and political attention and as a result political forces have been at work in Germany in an attempt to limit banks' influence over the governance of large companies.[39]

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37. Commenting on this Harm states that it is likely that the combination of equity ownership, board membership and creditor of the same company influence bank representation of other shareholders. -Harm, C. The Relationship Between German Banks And Large German Firms, 1992, Policy Research Working Paper, 19

38. Baums T, Takeovers v. Institutions in Germany, in D.D. Prentice and P.R.J. Holland (eds), Contemporary Issues In Corporate Governance, 1992, 155, Clarendon Press; Prowse S, Corporate Governance In An International Perspective : A Survey Of Corporate Control Mechanisms Among Large Firms In The United States, United Kingdom, Japan and Germany, 1995, at 25, New York University, Solomon Center; Dornberg J, The Spreading Might Of Deutsche Bank, New York Times, September 23, 1990, 28

39. Protzman F, Mighty German Banks Face Curbs, New York Times, Nov 7, 1989 at D1, where it is reported that the German parliament has begun studying steps to limit banks' voting power, seats on supervisory boards and their general influence in corporate decision-making.

Managers in large companies have also opposed bankers' influence and significant representation on the supervisory boards and are urging that laws be put in place to reduce their dominance over companies.[40] The German government has also shown an intention to curb banks' powers by limiting the depository shares that a banks may hold and vote on behalf of other shareholders.[41]

Large German banks have, however, bowed to this pressure by lowering their public profile and announcing that they will not fight curbs on their power over the proxy machinery and other channels of control.[42] Along these lines German banks have started to vote their shares less aggressively in addition to moves towards reducing industrial holdings in large German companies[43]

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40. Roth T, West German Banks Face Threat Of Reduced Influence In Industry : Bonn Will Consider Rules To Curb Their Holdings And Seats In Boardrooms, Wall Street Journal, July 18, 1989 at A20 where it is stated that "with main stream politics coming into play, bankers worry that they will be forced to sell part of their sizeable equity holdings in West German industries, thus threatening their dominant position in the country's equity market".

41. Economist, Those German Banks and Their Industrial Treasures, (1995) Economist, Jan. 21, 91-2; Also Chenoff, J., German Banks May Face New Rules Pensions and Investments, 1994, 42

42 Kubler F.K, Institutional Owners And Corporate Managers : A German Dilemma, 1991, 57 Brook. L. Rev., 97 at 101.

43. Fisher, A. Germany 97: Banking: Shake-up Sharpens Focus, Fin. Times, Nov. 18, 1997, 7 – states that Deutsche Bank produced a bombshell with its surprise five per cent stake in Bayerische Vereinsbank, the big Bavarian bank. This move has marked a radical departure from its traditional policy of holding large stakes in companies.

D) PROXY VOTING IN THE UNITED STATES

Prior to 1934 there were serious abuses of the proxy voting system in the United States and the methods used then to obtain proxies were often startling. Some companies even included statements creating proxies on the back of each dividend cheque that they sent out to their shareholders.[44] The U.S. has now regulated proxies to a much greater extent than the U.K, the most important legislative intervention being Rule 14a of the Securities Exchange Act 1934.[45]

1. Statutory Development Of Proxy Voting

As in the United Kingdom, the right to vote by proxy at corporate meetings in the United States was not recognised under common law. In Philips v. Wickham,[46] expressing the opinion that voting by proxy was not a common

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44. Vagts D.V, Basic Corporation Law, (1989), 3rd Ed. 403, Foundation Press

45. On this Hornstein comments that the SEC rules give shareholders a chance to play an important role in corporate governance. - Hornstein, J.A. Proxy Solicitation Redefined: The SEC Takes An Incremental Step Towards Effective Corporate Governance, 1993, 71 Wash. Uni. L. Q., 1129, 1133-34; Also Salwen K.J., SEC To Allow Investors More Room To Talk, Wall ST. J., Oct. 14, 1992 at C1, notes that the SEC rules have enabled shareholders to participate more effectively in corporate governance.

46. 1 Paige N.Y. 590 (1829)

law practice, the Chancellor stated :

> "The right of voting by proxy is not a general right and the party who claims it must show a special authority for that purpose."[47]

During the late eighteenth and early nineteenth centuries in the United States, clauses in special legislation expressly provided for proxy voting for the first time. In 1811 the state of New York adopted a statute which constituted the first general legislation on companies. This statute contained the following provision on proxy voting :

> "And be it further enacted, that the stock property, and concerns of such company shall be managed and conducted by trustees ..... and the election shall be made by such of the stockholders as shall attend for that purpose, either in person or by proxy ....."[48]

In North Carolina the 1829 Laws had a provision which granted corporate members the right to vote by proxies. It provided :

> "any proprietor by writing, under his or her hand executed before two witnesses, may request any other member or proprietor to vote and act as proxy for him or her at any general meeting."[49]

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47. At p. 597. Also Brown v. Commonwealth, 3 Grant Cas. (Pa) 209 (1856)

48. New York Laws (1811), Chap. 69 para. 3 p. 123

49. North Carolina Laws (1829), Chap. 35 para. 2 p. 32

Likewise the State of Maryland, in 1838, adopted an Act which prescribed regulations for the incorporation of manufacturing and mining companies. Among other things that Act provided :

> "the stockholder shall be entitled to one vote for every share owned by them respectively, up to the number of fifteen inclusive ..... and they may vote in person or by proxy."[50]

Although most states had legislative provisions of one kind or another which granted shareholders the right to vote by proxy, where governing statutes were silent on the subject, shareholders ensured that provisions were included in their company's articles which secured them this right. It is, therefore, worthwhile to look at the consequences of these self-help attempts by shareholders to secure the right of voting by proxy for themselves.

In the Connecticut case of State ex rel Kilbourn v. Tudor [51] there was no clause in the governing statute empowering the members to vote by proxy but an article authorised proxy voting. At one of the general meetings some shareholders sought to cast their votes by proxy but the presiding officer rejected the votes. It was held that the votes should have been received.[52]

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50. Maryland Laws (1838), Chap. 267 para. 5 p. 149; Also N.J. Laws (1840) para. 3 p. 123; Pa Laws (1849), No. 368, para. 4 p. 563

51. 5 Day (Conn) 329 at 333 (1812)

52. At p. 333

This position was approved in Walker v. Johnson where the court commented that :

> "the great weight of authority in this country sustains the proposition, that where the charter of a trading corporation is silent upon this question, the power is implied to enact a by-law conferring the power to vote by proxy." [53]

2. Federal Regulation Of Proxy Voting

In the United States the efficacy of shareholder participation in the corporate electoral process through the use of proxy voting was called into question as far back as the early 1930s. Since many shareholders voted by proxy, corporate decision-making sometimes hinged on which of two opposing sides could gather enough proxies to win a vote at shareholders' meetings, hence the name "proxy contests".

Before the United States proxy regulations were put in place corporate management was able to perpetuate itself in office through the use of the unregulated proxy facilities.[54] At the time directors did not attach much importance to the requirement that corporate information had to be disclosed

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53. 17 D.C. App. 144 at 163 (1900)

54. Livingstone, J.A., The American Stockholder, 1955, Lippen Cott. Co. 30

to shareholders, which made it difficult for members to take any view on corporate policy issues.[55] As a result it was recognised that for the proxy voting machinery to fulfil its objective of affording shareholders the opportunity of appointing others to exercise their voting rights, its regulation was a practical necessity. In order to address this issue the United States Congress enacted Section 14(a) of the 1934 Securities and Exchange Act.

Its provision constitutes the statutory basis for the federal regulation of proxy solicitation and proxy voting in the United States to date. It provides :

> "It shall be unlawful for any person by the use of the mail or by any means or instrumentalities of interstate commerce or of any facility of any national securities exchange or otherwise, to solicit or to permit the use of his name to solicit any proxy or consent or authorisation in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest ....."[56]

The need for such regulation was emphasised by the House Report of the United States Congress.[57]

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55. Aranow E. & Einhorn H, Proxy Contexts For Corporate Control 89 (2nd ed. (1968)

56.H.R. Rep. No. 1383 73d Cong. 2d Sess. 96, 1934

57. See Cong. Rec. E-1142, Jan. 12, 1933.

3. The Regulation Of Solicitation

Solicitation as regulated by Section 14a has been described as the process of systematically contacting shareholders and urging them to execute and return proxy cards which authorise named proxies to cast the shareholders' votes, either in a manner designated in the proxy card or in accordance with the proxy's discretion.[58] The courts have also interpreted this term very broadly. In SEC v. Okin[59] the defendant shareholder sent a letter to fellow shareholders in connection with an annual meeting asking them not to sign any proxies for the company and to revoke any proxies that they may already have signed. The court held that the defendant's actions constituted a proxy solicitation.

In Sargent v. Genesco, Inc[60] a letter which management sent to shareholders stated the company's financial difficulties and endorsed the terms of a refinancing plan. The letter did not expressly call for a shareholder vote on the issue. It was held to constitute a solicitation even though no meeting was scheduled. The reasoning was that whether a particular action constitutes a solicitation or not depends on both the nature of the communication and the circumstances under which it is transmitted. The court emphasised that in

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58. Bernstein S. and Fischer, H., The Regulation Of The Solicitation Of Proxies: Some Reflections On Corporate Democracy, 7 U. Chi. L. Rev. (1940) 226

59. 132 F. 2d 784 (2d Cir. 1943)

60. 492 F. 2d 750 (5th Cir. 1974)

this instance the purpose of the letter was to persuade shareholders not to oppose the proposed financial plan.

On the other hand the courts have attempted to strike a balance between proxy solicitation and the furnishing of material corporate information. Where disclosure of information to shareholders is for the purpose of seeking their comments on corporate performance the courts are less likely to hold that a solicitation has been undertaken. In Smallwood v. Pearl Brewing Co.[61], a company needed shareholders' approval of a merger. One month before mailing the proxy statement, the company sent shareholders a letter stating that the board favoured the merger's approval. The court held that this communication from the company's management was not a proxy solicitation but a mere disclosure of material corporate information.

4. The Securities Exchange Commission Rules

Section 14 (a) of the Securities Exchange Act 1934 can only be violated where there are SEC rules to implement it. Rules were promulgated by SEC to ensure that shareholder voting was not only facilitated by the proxy voting system but that the mechanics of this facility were implemented fairly. The proxy rules provide a four-way approach to shareholders' voting problems. Firstly, the rules provide shareholders with the opportunity of soliciting proxies from fellow shareholders and the right to have their proposals included in their company's proxy statement. Secondly, they require disclosure of material information from opposition groups in a proxy contest.

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61. 489 F. 2d 579 (5th Cir.), 419 U.S. 873 (1974)

Thirdly they prohibit the solicitation of proxies by the use of misleading information in a fraudulent manner. Finally the proxy rules require full disclosure of material information to be made available to shareholders on management proposals for corporate decisions. These will now be considered in turn.

a) Communication By Shareholders

Rule 14a-8 makes it obligatory for management to include a shareholders' proposal in its proxy statement if the shareholders notify management of their intention to present the proposal for action at a forthcoming shareholder meeting. Where management opposes a shareholder's proposal it should, at the request of the shareholder, include in its proxy statement a presentation by the shareholder of not more than 200 words in support of his proposal.

A shareholder's proposal can, however, be properly excluded if it falls under the enumerated instances of Rule 14a-8(1)(13) . An example of this is that a shareholder' s proposal may be excluded from management proxy material if it involves matters that are not proper subjects for shareholder action under the laws of the company's domicile.

Rule 14a-11 provides the opportunity for shareholders who wish to elect nominees to the board, other than those recommended by management, to engage in their own proxy solicitation[62]. Under Rule 14a-7 such shareholders may obtain, at management's option, either a complete shareholder address list or a mailing of the shareholders' proxy materials by the corporation at the shareholders' expense.

62. The SEC rules as amended in 1980 - 17 C.F.R. S. 240 14a-11 (1980)

b) Disclosure By Opposition

The U.S. proxy rules require detailed disclosure by opposition groups in a proxy contest. Rule 14a-11 requires that if there is a solicitation by a person (or a group of persons) which opposes a solicitation by any other person or group with respect to the election or removal of directors, certain information should be disclosed. Such information includes the identity of the parties concerned, the extent of their financial interests in the company and involvement in previous proxy contests. This requirement ensures that shareholders are adequately informed and can thus vote intelligently after disclosure by management and management's opposition group.

c) Prohibition of False Or Misleading Information

Rule 14a-9 prohibits false or misleading information in communications involving proxy solicitations. In applying this particular rule the courts take into account the nature of the statement, the context in which it was made and the individuals to whom it was made. In J. I. Case Co. v. Borak[63] the United States Supreme Court, taking into consideration the circumstances in which misleading information was given, stated that there could be a private cause of action under Section 14 of the Securities and Exchange Act of 1934. On that basis the court imposed liability on those persons who solicited proxies in violation of rule 14a-9.

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63. 377 U. S. 426 (1964)

d) Disclosure Of Information To Shareholders

Rule 14a-3 regulates the information which should be furnished to shareholders. This rule provides that proxies can only be solicited if each person soliciting has complied with the requirements pertaining to information specified in Schedule 14A. This schedule requires a detailed disclosure of matters to be voted upon at the meeting. Where the solicitation is by management, information about the directors or nominees of directors should be furnished including their names, occupations, remuneration and financial interests in the company. Under Rule 14-3(b) if the solicitation is made on behalf of management prior to an annual meeting of shareholders during which directors will be elected, each proxy statement is required to be accompanied or preceded by an annual report. The report is required to contain specific information concerning the financial position and management of the company.

Rule 14a-4 regulates the form of proxy document and provides that shareholders should have the opportunity to approve or disapprove each matter submitted to them, and, if the proxy involves the appointment of directors, members should be given the chance to vote for or against the directors nominated or to withold the right to vote at all. Under such a circumstance, Section 14a-4d requires that a proxy may not confer authority to vote on any person who is not named in the proxy statement as a bona fide nominee. Rule 14a-6 requires all proxy-soliciting materials to be filed with the SEC in advance of distribution to shareholders.

5. Criticisms Of The SEC's Proxy Rules And Their Amendments

With the increase in institutional investors' activism, scholarly attention in the late 1980s and early 1990s began to focus on the degree to which the proxy rules impeded collective action by shareholders as communication among them was not encouraged. The main thrust of these criticisms was that the rules served to deter insurgent shareholders and protect incumbent management. It was argued that the rule which permitted incumbents to receive full reimbursement while insurgents were compensated only if they succeeded and gained control of the board was unfair. This disadvantageous position of shareholders had moved Professors Bebchuk and Kahan to urge that insurgents should be partially compensated based on the percentage of the vote received for their proposal.[64]

The second criticism was that the proxy rules discouraged shareholder activism since it defined the key term "solicitation" to include any communication that was reasonably likely to cause the person solicited to give or withhold a proxy to management. This implied that any criticism that might cause other investors to withhold their proxy was solicitation. It had the effect of preventing large shareholders from taking appropriate actions against management thus insulating corporate management.

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64. Bebchuk L. and Kahan M., A Framework For Analysing Legal Policy Towards Proxy Contests, 1990, 78 Calif. Law Review 1073, 1081,

The third criticism was that shareholders were prevented by the proxy rules from effectively co-ordinating their actions to maximise their influence at general meetings as this could be regarded as solicitation.[65] Under the old proxy rules shareholders were subject to costly and burdensome filing and disclosure requirements.[66] Those who contravened this rule were subject to the same consequences as management, including disenfranchisement with regard to the votes in question.[67]

In 1989, the California Public Employees Retirement System (CalPERS) submitted a series of proposed proxy rule amendments to SEC, accompanied by a lengthy critique of the existing proxy rules, which proposed that SEC's over-regulation of the proxy voting process discouraged dissident shareholders. In response the Commission undertook a study which resulted in the issue of Securities Exchange Act Release No. 34-29315, June 17 1991, with three significant changes being proposed:

a) Where a shareholder was not seeking to obtain proxy authority, but was simply responding to a solicitation, the shareholder was not obliged to make any prior filing with the SEC or to distribute a proxy statement.

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65. Black B., Shareholder Passivity Re-examined, 1990, 89 Mich. Law Review 520, 525

66. Rule 14a-11

67. Committee For New Management Of Butler Aviation v. Widmark, 335 F. Supp. 146 (E.D.N.Y. 1971)

b) The SEC proposed to eliminate the requirement of prior review of proxy material. Previously, before a proxy statement or material could be used for proxy solicitation, SEC review and approval was necessary. The review process often took several weeks, with the delay working to the incumbent management's advantage since the particular meeting might have been held before the approval was given.

c) The Commission proposed to give a person seeking to make a proxy solicitation a right to receive a shareholders' list from the company.

Previously Rule 14a-7 gave the company the option of providing a list or mailing a proxy statement to the person making the solicitation at the latter's expense. The 1991 proposals reverse this option, giving a dissident shareholder the right to have the list sent to him or her.These proposals generated heated controversies with the result that the SEC withdrew them in late 1991 for a further study. Finally in October 1992, the Commission adopted a compromised package of reforms in Securities Exchange Act Release No. 34-31326.[68]

Although the Commission, in the 1992 Release, abandoned its original idea of giving shareholders a right to receive a shareholder list, it stuck to its central precepts that :

a) a person not seeking to obtain proxies should be free to communicate with

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68. Securities Exchange Act Release No. 34-31326 (16 October 1992)

other shareholders without any obligation to make any prior filing with the SEC or to prepare a proxy statement, and

b) the costs of complying with the proxy rules needed to be reduced for those who did solicit proxies.[69]

To some extent, the 1992 amendments to the proxy rules have made the process less burdensome for shareholders with the effect that members are now free and more willing to communicate with others. Shareholders, for example, were able to take advantage of these new rules to stage a successful revolt against a major management initiative at K-mart Corporation.[70] Activists have reported that co-ordinating other shareholders' support has become much easier under the new proxy rules.[71]

Overall, the new rules go a long way toward answering the criticisms that the former proxy rules prevented institutions and shareholders in general from effectively co-ordinating their actions to improve the performance and governance of their companies. Under the new rules investors can,

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69. This 1992 Release was codified at 17 D.C.F.R. Ss. 240 14a-1 to - 103 (1994)

70. Duff C, Kmart Investor Join Opposition To Stock Plan, Wall Street Journal, June 1, 1994, at A4

71. Scism L, Border Activists' Success Raises Fairness Questions, Wall Street Journal, Dec 15, 1993 at C1, C22

therefore, take actions as a group to maximise their influence at general meetings.

E) CONCLUSION

Proxy voting which was designed to encourage corporate democracy and to help return some measure of control to shareholders has not been completely successful in rousing shareholders from their passivity. Although shareholders have the power to remove directors it can be a difficult task, in the face of management control of the proxy voting machinery, for members to exercise this right. Even when directors are removed their successors are nominated and appointed to the board by the remaining directors and not the shareholders.[72]

Shareholders have not achieved the level of participation and control which the proxy machinery was supposed to give them. Proxy voting as currently constituted in the U.K. is, therefore, not an ideal system for expressing shareholders' views. While this system of voting is available to absent shareholders, the exhorbitant costs and adversarial nature of proxy contests deter shareholders from using the machinery to oppose management openly. The advantages that incumbent management has enable it to retain control almost without any reasonable opposition.

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72. Blaire M.M, Ownership And Control, Rethinking Corporate Governance For The Twenty-First Century 1995, 70, The Brookings Institution

Having access to the company's resources, management is in the best position to solicit proxies from shareholders and is normally successful in obtaining a large majority of them. Since the outcome of proxy voting is crucial to shareholder participation in corporate decision-making, it is surprising that up to date there is no meaningful form of regulation in the U. K. to guide this voting machinery. The Stock Exchange simply requires companies to send out a two-way proxy form whenever notices of general meetings are being sent out to shareholders.

One of the main differences between proxy voting in the U.K. system and that as practised in Germany is that while corporate managers control the proxy mechanism in the U.K. it is doubtful whether German managers can even lawfully make a proxy solicitation. German banks do not solicit proxies to be exercised by management proxy committees as is the practice in the U. S. The power of German banks is partly offset by the power of labour through the institution of codetermination which does not exist in the Anglo-American system. A core problem is, however, that in their multiple roles German banks are in a position to impose their outside interests on the company to the detriment of other shareholders.

Proxy voting in the U. S. has come under more stringent regulation than in the other systems under study. There have been serious attempts in that jurisdiction to prevent the proxy machinery from being abused by management. The United States SEC rules attach a lot of importance to disclosure of information and give shareholders the opportunity to communicate among themselves. This enables shareholders to make informed decisions on matters affecting their interests thus maximising their influence at general meetings. These rules have gone a long way in promoting the exercise of shareholders' voting rights even when they are absent from general meetings.

Proxy voting in the U. K. and Germany is yet to experience the level of regulation which this voting machinery has been subjected to in the U. S. Although the Companies Act sets out rules which are to regulate proxy voting, important issues such as proxy solicitation and disclosure of material information to shareholders have not been addressed. Neither system makes shareholders an influential factor in the corporate decision-making process. A lesson can, therefore, be learnt from the developments in the U. S. in this area of law where the regulation of the proxy voting system brings about a balance between management proposals and the proper exercise of shareholders' rights. The development of clear rules in the U.S. should therefore encourage these other systems to take the necessary steps to ensure that rules are put in place to ensure effective proxy voting by shareholders.

CHAPTER SEVEN

DISPROPORTIONATE VOTING ARRANGEMENTS

A) INTRODUCTION

Company shares can generally be described as carrying two main rights - dividend rights and voting rights. The right to vote provides shareholders with the mechanism through which they can exercise some control over directors[1]. Although ordinary shares normally have the same dividend rights per share, the voting right attached to each share might differ. Where it is sought to allocate control in a company in a way other than that reflected by the actual amount that shareholders have invested in the company, a device commonly used is to create classes of shares with different voting rights.

Companies with disproportionate voting powers of shares may have one class of ordinary shares being denoted as having one vote per share while another class of shares may have no voting rights at all. Another option is the German practice where a company has a basic 'one share, one vote' system but no individual shareholder would be entitled to cast more than a specified number of votes regardless of how many shares they possess. As

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1 To this effect Bebchuk and Kahan have stated that voting rights of shareholders constitute a major element in the structure and control of a company - L.A. Bebchuk & M. Kahan, A Framework For Analyzing Legal Policy Towards Proxy Contexts, 1990, 78 Cal. L. Rev. 1071 at 1073.

far as the owners of non-voting shares are concerned, such shares are merely a form of investment which does not entitle them to intervene in the management of their company.

Although one vote per share is the rule in most companies in the U.K., the attachment of disparate voting rights to shares is still used by some companies. In the U.S. one vote per share was the practice on the New York Stock Exchange from 1926 until 1986. Under German corporate practice, while the issue of disproportionate voting shares is not the norm, other voting restrictions are employed. These restrictions have the effect of denying shareholders of their full voting rights.

As one of the property rights of shareholders is the right to vote at general meetings, this chapter will analyse the effect of disproportionate voting arrangements on shareholders' ability to appoint and remove directors through the exercise of their voting rights.

B) DISPROPORTIONATE VOTING UNDER U.K. LAW

The main rules concerning attendance and voting at general meetings of companies are usually set out in the company's articles of association. Some companies issue different classes of shares with provisions in the articles conferring multiple voting power on one class, limited voting rights on another, or even completely denying voting rights to a particular class. The main purpose of issuing disproportionate voting shares is the retention of voting control within a selected class of shareholders while providing for corporate expansion and financial flexibility.

1. Multiple Voting Rights

Multiple voting grants a particular class of shareholders more votes than are proportionate to their shareholding. A typical scheme of multiple voting is where a company creates two classes of ordinary shares - Class A and Class B. Class A shares would have all the normal attributes, including one vote per share, while the class B would have these attributes with three exceptions:

1. Ownership of Class B shares would normally be non-transferable.
2. Class B may be converted into Class A shares which would be freely transferable.
3. Class B shares would enjoy multiple voting rights.

Since Class B shares would not be transferable, if shareholders in that class wanted to sell their shares they would first convert them to Class A shares. Over a long period, there would inevitably be a reduction in the number of outstanding Class B shares. Under such circumstances, incumbent managers would be more likely to retain their class B shares with the result that these superior voting shares would gradually concentrate in the hands of management. The effect of this would be that directors with superior voting powers would be protected from being removed.

Sometimes companies include in their articles a method of voting in a particular circumstance which affects all shareholders in that of the company. This was the position in Bushell v. Faith,[2] where a company had a capital of £300 in £1 shares. Faith and his sisters, Mrs Bushell and Dr Bayne were the three members and each held 100 shares. Article 9 provided that for the removal of any director shares held by that director on a poll in respect of such resolution would carry the right to three votes per share.

On a proposal to remove Mr. Faith from the board he was able to record 300 votes as a result of this article therefore outvoting his sisters, who recorded 200 votes between them. The House of Lords, upholding the effectiveness of article 9, stated:

> "Parliament has never sought to fetter the right of the company to issue a share with such rights or restrictions as it may think fit. There is no fetter which compels the company to make the voting rights and restrictions of general application and it seems to me clear that such rights or restrictions can be attached to special circumstances and to particular types of resolutions. This makes no mockery of Section 184 (now Section 303 Companies Act 1985); ....Had parliament desired to go further and enacted that every share entitled to vote should be deprived of its special rights under the articles it should have said so in plain terms by making the vote on a poll one vote one share."[3]

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2. [1970] AC 1099

3. At p. 1116

This practice of giving multiple voting power to a class of shareholders was also upheld in an earlier case. In Rights and Issues Investment Trust Ltd v Stylo Shoes Ltd.[4] which had to do with increasing the issued share capital of a company and not the removal of directors, the court upheld the validity of a resolution which doubled the voting rights of the management shares from eight votes per share to sixteen votes per share. The resulting effect of such an arrangement is that the class with minority equity shares might end up having the majority votes on all or specific occasions.

In recent times, however, companies with unequal voting rights of ordinary shares have taken steps to change their share structure. Whitbread, a brewing, retailing and leisure group, has reformed its 45-year-old share structure to give equal voting rights to all shareholders. Multiple voting rights enjoyed by a particular class of Whitbread shareholders had been under attack for some time. This move for change was made after institutional shareholders pressed for changes to the company's outdated dual share structure which gave holders of class B shares twenty times the votes of class A holders[5]. Hammerson, one of UK's leading international property investment companies, followed the example of Whitbread by reforming its two-tier voting structure that same year[6]. This modern trend has resulted from questions raised on the separation of ownership and voting in companies.

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4. [1965] Ch. 250

5. Rawstome P, Whitbread Gives Equal Rights, Fin. Times, Oct. 7, 1993, 25

6. Taylor P, Hammerson Share Vote Changes, Fin. Times, Oct., 20 1993, 22.

An alternative voting device to multiple voting shares which is used to vest control in a specific group is the issue of fractional shares. This is done by dividing up the class of shares that is to be given control into small denominations thereby increasing its voting strength. An example is where a company with £100,000 share capital has £75,000 worth of class A shares with par value of £1 each thereby having 75,000 votes, while the remaining £25,000 worth of class B shares could be given 10p par value thereby possessing 250,000 votes.

2. Preference Shares

The provisions of a company's articles often state that the holders of preference shares are not entitled to receive notices of or to attend or vote at general meetings in respect of their shares except in certain circumstances[7]. It is normal for the articles to indicate that they have the right to vote on any resolution involving a variation of their rights or a winding up. Usually, cumulative preference shareholders are given voting rights during any period when their dividend has not been paid in full for longer than a specified period. In the 1990 case of Re Bradford Investment plc'[8] the articles of a

7. For this reason preference shares are often regarded as a hybrid between share capital and loan capital – Farrar, J.H.and Hannigan B.M.,Farrar's Company Law, 1998, 230, Butterworth.

8. [1990] BCC 740

company provided that the preference shareholders had the right to vote if dividend had not been paid in full six months after the due date. Dividend was not paid to preference shareholders and they exercised their voting rights over the appointment of directors. It was held that the shareholders were entitled to vote in such circumstances whether or not there were profits out of which dividends could have been paid. According to the court:

> "... those provisions must be construed in accordance with the obvious purpose of giving a vote to preference shareholders whose dividends are in arrears, namely to allow them to participate in the selection of management of the company or any other matter entrusted to a general meeting. The right is needed precisely in the case in which insufficient profits have been made..."[9]

An alternative arrangement is where directors use a scheme called an exchange offer whereby shares with higher dividend rights but lower voting rights are given to public shareholders in exchange for their original shares. This device is normally utilised by company management with the knowledge that public investors who are more interested in higher rates of dividend than control over decision-making processes, will be attracted by it.

3. Non-Voting Shares

Many UK public companies have issued non-voting ordinary shares with the

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9. At p. 746

aim of ensuring that control is retained by a small proportion of equity holders. This development gave rise to the demand that the Stock Exchange should refuse to list such shares, or failing that, that the legislature should intervene. Today non-voting shares are the simplest and most straight-forward method whereby directors can render themselves irremovable without their own consent, despite the fact that they may only own or control a small fraction of the total equity shares in the company.

The objections to non-voting shares are strongest in the case of publicly quoted companies, particularly with the current movement to encourage the spread of shareholding amongst small private investors and more activism on the part of institutional shareholders[10]. The Jenkins Committee, which deliberated on the possibility of imposing legislative control over the issuance of non-voting shares, was divided on the issue[11]. After giving recognition to the fact that non-voting shares strip shareholders of their property right by denying them any level of control over their company, the majority took the view that it would be too drastic a step to prohibit the issue of shares with no voting rights.

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10. Jenkinson and Mayer, The Assessment: Corporate Governance and Corporate Control, 1992, 8(3) Oxford Review of Economic Policy1 at 2

11. Report of the Company Law Committee (Jenkins Report) 1962, Cmnd 1749.

Although the minority of the committee supported submissions made in favour of restricting the growth of non-voting shares, in the end no step was taken to prohibit them. The nearest that the law has gone to this option has been Section 370(6) of the Companies Act 1985[12] which states that for a company having a share capital, every member has one vote in respect of each share or each 10 of stock held by him; and in any other case every member has one vote. The Stock Exchange on its part still permits the issuance of non-voting or restricted voting shares[13] but simply requires that such shares should be clearly labelled.

In the Jenkins Report a minority of three recommended that all equity shareholders should have a right to attend and speak at meetings and that there should be a prohibition on the listing of non-voting or restricted voting equity shares[14]. No legislative action has been taken on this recommendation up till date although opposition by institutional investors has caused the issue of non-voting shares to be less frequent[15]. In addition some UK companies

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12. This provision states that in the case of a company originally having a share capital, every member has a vote in respect of each share or each £10 of stock held by him; and in any other case every member has one vote.

13. Section 9, Chapter I, para 11, Yellow Book or Chapter 13, App I, para 2, The Listing Rules.

14. Jenkins Report, Cmnd. 1749 pages 207-210

15. Wright, S, Two Cheers For The Institutions, 1994, 38-42, Social Market Foundation, London.

are now enfranchising their non-voting shares. James Beattie, a department store group, has loosened the grip of the founding Beattie family and given holders of its 48 million A class ordinary shares voting rights[16]. Barr & Wallace Arnold Trust, the motor and leisure group, has enfranchised its non-voting A shares which are owned mostly by institutions[17].

C) DISPROPORTIONATE VOTING RIGHTS UNDER GERMAN LAW

Under German law, shares may be issued with various rights attached to them particularly as to the distribution of profit and the exercise of voting rights. The freedom to issue shares with disparate voting rights is much narrower than that under the Anglo-American system because of the detailed prescription on voting rights by the Limited Liability Company Act (GmbHG) 1980 and the Public Company Act (AG) 1965.

1. Voting Restrictions In Limited Liability Companies

There are statutory regulations of the voting rights of shareholders in German private companies where resolutions to approve a shareholder's activities as managing director are concerned or where the managing director is to be

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16. Price C, Beattie Gives Vote to "A" Holders, Fin. Times, June 2, 1995, 20

17. Wolffe R, Barr & Wallace Calls Enfranchisement EGM, Fin. Times, Nov. 4, 1994, 18; Also Blackwell D, Cornwell Parker To Enfranchise Its "A" Capital, Fin. Times, Sept. 25, 1996, 34

exempted from an obligation under the GmbHG. In addition, shareholders with conflicting interests may not participate in a resolution approving their actions.[18]

Similarly a shareholder will be deprived of voting rights if a resolution is to be passed to remove him from the position of a director. This is not the case under English law where enhanced voting rights may be enjoyed by the director who is to be removed which may have the effect of rendering the particular director irremovable[19]. Votes cast contrary to such a prohibition are void and where the votes were relevant to the result of the voting then the particular resolution can be declared void by the court.

2. Voting Restrictions In Public Limited Companies

Under German law, with the exception of preference shares, each issued share generally confers a statutory right to vote[20]. The number of votes given to each share is normally determined by its par value[21]. Multiple voting rights that exceed those attributable to the par value of a share are prohibited, but

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18. Section 47 para 4 GmbH 1980 (as amended) stresses the principle that no one should be a judge of his or her own case.

19. See Bushell v. Faith in the earlier part of this chapter at p. 244

20. Section 12(1) AktG 1965

21. Section 134(1) AktG 1965

the government may permit an exception which has to be included in the Articles of Incorporation. To this effect Section 12(2)[22] provides:

> "Multiple voting rights shall be prohibited. The highest authority with responsibility for economic affairs in the federal state in which the company is domiciled may grant exemption if required in order to safeguard overriding interests of the public welfare."

The articles of a company may provide the maximum number of votes that any one shareholder may cast regardless of the actual shareholding. The alternative device is for the articles to provide for voting to be done by graduation[23]. Graduation operates so that the first one million Deutsche marks of par value carries full voting rights, the second million carries half of the normal voting rights and shares in excess of DM 2,000,000 par value are not normally conferred with voting rights at all. By the sliding scale method, a shareholder who possesses more than a certain number of shares may cast proportionately fewer votes in respect of the excess. By these methods a company may protect itself against control by one major shareholder.

These limitations on the number of votes that any one shareholder can cast obviously modify the rule of one vote per share. To facilitate the enforcement of these limitations the articles may also provide that shares held by one shareholder on behalf of another may be included in the latter's holdings in

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22. Section 12(2), AktG BGB1.1 1120 1965

23. Section 134(1) AktG 1965

determining the applicability of the limitation.[24] In implementing the graduation method voting rights are not taken away from the shares which are in excess of the limit and so they are not required to be in any special form. The full exercise of voting right by the shareholder is, however, restricted, and if he transfers part of his holding, the transferee can exercise normal voting rights attributable to the shares acquired.

Maximum voting rights may be introduced, without the consent of the affected shareholders, by amending the articles.[25] Limitations on voting rights of these sort do not imply that excess shares are treated as non-voting shares. For the purpose of determining the total voting capital, all the voting shares are taken into account, including those which exceed the maximum voting limits.

Voting rights of German shareholders become exercisable only after full payment of the contribution in respect of the shares has been made.[26] The statute may, however, confer voting rights when payment of only part of the contribution has been made. In such cases voting rights are exercisable in proportion to the amount paid up on the share.[27] In other cases voting rights

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24. Ibid.

25. Amendments to the Articles require a three-quarter majority unless the Articles provide for another majority - See S.179(2) AktG 1965. The dissentient shareholders can be the ones whose voting rights are being limited.

26. Section 134(2) AktG 1965.

27. Ibid

may not be exercised at all, either because the shareholder's rights are suspended or because the exercise of voting rights on certain resolutions are prohibited. Under Section 20,[28] for example, if a company which has acquired a substantial holding in another company has not notified that other company of its holding, all the rights in respect of its shareholding are suspended until it does so.

Furthermore, if a subsidiary of a company holds shares in it, the subsidiary may exercise neither voting rights nor subscription rights on an increase of capital[29]. Section 136 (1) of the same act provides that a shareholder cannot vote on resolutions at general meetings to discharge himself or herself from liability for breaches of duties owed as a member of a company's management or supervisory board.

3. Preference Shares

As in the U. K., preference shares normally have a specified percentage rate of dividend payable on the shares out of the company's profits with the possibility of cumulative rights to dividends. Where they have cumulative rights, payment of dividends in respect of the years during which the company makes no profit may be made retrospectively from the profits of later

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28. Section 20, AktG 1965

29. Sections 136(2) and 56(2) AktG 1965.

years. Under Section 140,[30] shares with cumulative rights or retrospectively payable preferential dividends may be issued as non-voting preference shares. Such shares are not completely deprived of voting rights but the rights cannot be exercised as long as the preferential dividend continues to be paid.

If, however, the preferential dividend is not paid, or is not paid in full, in a particular year and the dividend remains wholly or partly unpaid at the end of the succeeding year, the shares will enjoy voting rights for as long as the arrears of the dividends remain unpaid. Section 141, however, restricts the issue of this class of shares to not more than one-half of the company's issued capital. This again reflects an important difference between the voting rights of German shareholders when compared to those of their UK counterparts.

Under UK law there is no limitation on the percentage of preference shares that can be issued by a company as long as they are clearly identified as preference shares. Another important difference between these two systems is that generally under German law shareholders are given equal treatment with each shareholder having the same benefits and opportunities. This is evidenced in the fact that non-voting shares and the issue of shares with multiple voting rights are prohibited by Section 12.

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30. Section 140, AktG 1965

D) DISPROPORTIONATE VOTING UNDER UNITED STATES LAW

The need for restraint on the power of corporate management has received continuous attention in the U. S. by way of legislative action, court decisions, comments and discussions by academics. It has been recognised that corporate governance needs to be subject to certain restraints by federal and state laws. There is also great emphasis on the need to channel power to the appropriate organ in companies.

1. The Historical Development Of One Share/One Vote In The U.S.

As early as the 18th and 19th centuries there were moves by different states in the U.S. to adopt the one share/one vote rule in corporate charters. At the time three distinct systems of voting were adopted by states' corporate charters. A few states adopted the one share/one vote rule but others went to the opposite extreme of limiting the voting rights of large shareholders by imposing a maximum number of votes which any individual shareholder was entitled to cast.

Other states' corporate charters adopted a complicated formula by decreasing voting rights as the size of the investor's holdings increased. A good example of this is the Maryland charter which provides:

> "for one share, and not more than two shares, one vote, for every two shares above two, and not exceeding ten, one vote; for every four shares above ten, and not exceeding thirty, one vote; for every six share above thirty, and not exceeding sixty, one vote; for every eight shares above sixty and not exceeding

> one hundred, one vote; but no person, co-partnership or body politic shall be entitled to a greater number than thirty votes"[31]

By the second half of the nineteenth century, most American states' corporate charters had provided for one vote per share and most preference shares, at the time, had voting rights equal to those of the ordinary shares.[32] In 1852 Maryland's first General Incorporation Statute fell in line with the other states' statutes by adopting the one vote per share standard. New York's General Corporation Law of 1909, for example, entitled each shareholder to one vote per share unless otherwise provided in the certificate of incorporation.[33]

Two important deviations from the one share/one vote standard subsequently emerged. The first was the substantial limitation of voting rights given to preferred shares as the right of holders of this class of shares to vote was limited to the occurrence of certain contingencies such as non-payment of dividend, or the alteration of their class rights. This practice is still the modern norm both in the U.K. and the U.S.[34] The second deviation was the emergence of non-voting ordinary shares, one of the earliest examples of

31. Maryland Corporation Charter para. 1471 (1984)

32. Stevens, Stockholders Voting Rights And The Centralisation of Voting Control, 1926, 40 Q.J. Econ 353, 354

33. 1909 N.Y. Laws Ch. 28 para 23

34. Cox J.D., Hazen, T.L. and O'Neal, F.H. Corporations, 1995 , Chap. 18.5-18.7, Little Brown and Co

which was the International Silver Company whose ordinary shares, which were issued in 1898, had no voting rights until 1902 when one vote was allowed for every two shares.[35]

After 1918 a growing number of companies issued two classes of ordinary shares: one having full voting rights of one vote per share and the other having no voting rights but sometimes having greater dividend rights.[36] The main objective of this was that by issuing the former to insiders and the latter to the public, management could raise funds for the company without losing control. The dissatisfaction that resulted from this practice moved different sectors to call for the enfranchisement of non-voting shares and to do away with the two-tier voting structure. The increasing opposition to the issue of non-voting shares which emerged finally moved the U.S. courts and administrative bodies to take a strict stand where voting rights of shareholders were concerned.

2. Judicial Contribution

Different state courts in the U. S. have taken the stand whereby actions by directors that result in the manipulation of shareholders' voting rights are subject to strict judicial review. By taking this stand the courts have been

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35. Stevens supra note 32 at p. 355

36. Dewing A. S., The Financial Policy of Corporations, 1953, 163

careful to guard against attempts by directors to use their control over corporate processes to ensure their perpetuation in office. When it comes to shareholders' voting rights, courts have taken a firm stand on the prohibition of shares with special voting rights especially where such enhanced voting rights are given during contests for control.

In Asarco, Inc., v. M.R.H. Holmes A Court,[37] the district court objected to the issue of Class C preferred shares that would have had different voting rights from the existing Class C shares. The court stated that although the New Jersey Business Corporation Act permitted changes to voting rights between different classes of shares, it did not permit different voting rights to be created within a single class. The court emphasized that the right to vote is one of the inherent rights of a shareholder and there is no moral justification whatsoever for depriving shareholders of their right to vote."[38]

A number of cases in Delaware have also marked the most profound articulation of U.S. judicial view on directors' actions that affect shareholders'

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37. 611 F Supp. 468 (D.N. J. 1985)

38. Ibid at p. 474

voting rights. In Televest, Inc. v . Olson,[39] the court invalidated the issue of preferred shares which established majority voting requirements for certain transactions after finding that the directors acted to defeat a particular shareholder's control ambitions. In Phillips v. Institutform of Am., Inc.,[40] the court invalidated share issue and bye-law amendments which were intended to deprive majority shareholders of control over the company. The Supreme Court of Delaware, in Blasius Industries, Inc.v. Atlas Corp.[41], held that the actions of directors, designed for the primary purpose of interfering with shareholders' voting right had to be accorded closer scrutiny. It emphasised that:

> "Actions designed principally to interfere with the effectiveness of a vote inevitably involved a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal."[42]

In Pretty v. Penntech Papers, Inc.,[43] following the redemption of all preferred shares other than those owned by incumbent directors, the court stated that the use of corporate funds to purchase corporate shares, which was primarily

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39. No. 5798, 1479 WL 1759 at 7 (Del. Ch. March 1979)

40. No. 9173, 1987 WL 16,285 at 11

41. 564 A. 2d 651 (Del. Ch. 1988)

42. Ibid at p. 668

43. 347 A. 2d 140, 143 (Del. Ch. 1975)

aimed at maintaining management in control, was improper.[44]

American courts have also refused to recognise the validity of non-voting shares on the basis of states' constitutional provisions which have been construed so as to prohibit the issue of this category of shares. As far back as 1859, Section 3 of the Illinois Laws, provided that at general meetings of shareholders:

> "stockholders may vote, either in person or by proxy, one vote for each share of stock held and thus represented."

Futhermore, Art. XI of the Illinois Constitution 1870 contains a similar provision which has enabled the courts to hold that every shareholder is guaranteed an unqualified right to vote all shares registered in his name.

In State ex rel Watseka Telephone Co. v. Emmerson,[45] the court denied mandamus to enforce the issue of a corporate charter by the Secretary of State because the preferred shares of the proposed company denied shareholders the right to vote. It was held that the wording of the constitution declared its meaning and that the courts had no right to add or take away from that meaning.[46]

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44. Also Lennane v. Ask Computer System Inc. [1990-1991] Fed. Sec. L. Rep. (CCH) 95:674 at 98: 153 (Del. Ch. , Oct. 1990)

45. 302 Ill. 300, 134 N.E. 707 (1922)

46. Durkee v. People ex rel Askren, 155 Ill. 354, 40 N.E. 626 (1855)

Consistent with this is the West Virginia Constitution which provides:

> "The legislature shall provide by law that in all elections for directors or managers of incorporated companies, every stockholder shall have the right to vote, in person or by proxy, for the number of shares of stock owned by him, for as many persons as there are directors or managers to be elected, or to cumulate said shares, and give one candidate as many votes as the number of directors multiplied by the number of shares of stock, shall equal, or to distribute them on the same principle among as many candidates as he shall think fit, and such directors or managers shall not be elected in any other manner."[47]

On the basis of this provision the West Virginia Supreme Court of Appeal, in Dewey Portland Cement Co. v. O'Brien,[48] held that insofar as the constitution of West Virginia guaranteed to every shareholder the right to vote in the election of directors, the issue of shares stripped of voting rights could not be tolerated.[49] The Pennsylvania Business Corporation Law provides

> " Except as otherwise provided in the Articles and this Act, every shareholder of record shall have the right, at every shareholders' meeting, to one vote for every share standing in his name on the books of the corporation."[50]

The Pennsylvania Bureau of Corporation has given a clear interpretation to this section by insisting that the only permissible deviation from one vote per share is no vote at all. Using this provision of law the Supreme Court of

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47. Art. XI S. 4 of 1872

48. 96 S.E. 2d 171 (W. Va 1957)

49. Also Germer v. Tripper-State Natural Gas and Oil Co., 60 W. Va. 143, 54 S.E. 509 (1906)

50. 1933 as amended

Pennsylvania, in Commonwealth, ex rel Cartwright v. Cartwright,[51] held that disproportional shares could not be voted in a company where the by-laws provided for only one vote per share. According to this court if the arrangement was allowed it would create a situation which was not intended by the by-law.

Missouri Supreme Court has interpreted a similar constitutional provision so as to protect shareholders. Where the corporate charter entitles shareholders to vote in elections of directors any manipulations which might deprive the minority of their property rights will be disallowed.[52] In State ex rel Frank v. Swanger,[53] the court stated that shareholders should have the right to vote their shares. According to the court, where this well-recognised common law right is taken away there is a complete distortion of the law's very purpose. Elaborating on this same point the court in the earlier case of Gregg v. Granby Mining and Smelting Co.,[54] stated:

> "It was evidently the purpose of our legislature to settle this question of stockholders' voting rights by a positive enactment......Thus the share is made the unit of election, and not the person who owns it, regardless of the number of his shares."

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51. 350 Pa. 368 (1944)

52. Section 6, Art. 12 of the Missouri Constitution (1875)

53. 190 Mo. 561 89 S.W. 872 (1905)

54. 164 Mo. 616, 625, 65 S.W. 312, 313 (1901)

3. Regulation By Administrative Bodies

There has also been, at one stage or the other, objection to disproportionate voting rights of shares by some American securities administrative bodies. In 1926 the New York Stock Exchange (NYSE) refused to authorise the listing of non-voting ordinary shares, however designated. The historical background to the NYSE's standard of one share, one vote started in 1925. At the time, a number of legal devices were developed by corporate management to maintain control, mainly 'pyramiding', non-voting shares and the voting trust.[55] According to Berle and Means in about 21% of the 200 largest American corporations in the early 1930s, control was attributable to a legal device.[56]

It was in the heat of these developments that the NYSE first disapproved the issue of non-voting equity shares in January 1926. Since then the NYSE has continued to oppose the abuses that have arisen from the practice of issuing disproportionate voting shares. Although this Stock Exchange has made no rule against the issue of disproportionate voting shares, its practice has been to enquire into such issues when they apply for listing, and to refuse to open the facilities of its market to issues where abuses of this practice seem likely to occur.[57]

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55. Cox, Hazen, and O'Neal , Corporations, 1995, 13.81, Little Brown & Co.

56. Berle A. and Means G., The Modern Corporation And Private Property 88-89 (New York, 1932, rev. ed. 1967)

57. Loomis & Rubman, Corporate Governance In Historical Perspective, (1979) Hofstr L. Rev. 141, 152-153

Along the lines of the NYSE position, the North American Securities Administrators Association (NASAA), in 1980, adopted a statement of policy declaring:

> "Unless preferential treatment as to dividend and liquidation is provided with respect to publicly offered securities or the differentiation is otherwise justified, the offering or proposed offering of equity securities of an issuer having more than one class of equity securities authorised or outstanding shall be considered unfair and inequitable to public investors if the class of equity securities offered to the public:
> a) has no voting rights or
> b) has less than equal voting rights, in proportion to the number of shares of each class outstanding on all matters, including the election of members to the board of directors of the issuer."[58]

The stand taken by these securities exchanges may have moved some other American States to enact Corporate Law Statutes which disallowed the creation of classes of shares which are stripped of voting rights or which had limited rights to vote. To this effect the Florida Corporation Code provided:

> " each outstanding share, regardless of class shall be entitled to one vote on each matter submitted to a vote at a meeting of shareholders."[59]

In line with this policy, seventeen other states in America have regulations which prohibit the issue of ordinary shares with unequal voting rights. These are Alabama, Alaska, Arizona, Arkansas, California, Indiana, Kansas, Louisiana, Minnesota, Missouri, Nebraska, South Carolina, Tennessee, Texas, Washington, Wisconsin, and Wyoming.

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58. See Statement of Policy on Non-Voting Stock, 1 NASAA Rep. (CCH) para. 2401

59. Section 212, Florida Business Corporation Code 1963

4. Recent Developments

The public interest in the debate over these state and national regulations of shareholder's voting rights may have moved the SEC to adopt Rule 19c-4 which limited the ability of U.S. companies to adopt disparate voting right plans. This rule prohibited the exchanges from listing an issuer's equity securities if the company issued shares which restricted or reduced the voting rights of shareholders.[60] This was SEC's first direct attempt at regulating, substantively, a matter of corporate governance applicable to all public corporations.

Although Rule 19c-4 was challenged by the U.S. Business Roundtable and invalidated by a court decision,[61] SEC used its influence to encourage the exchanges - the New York Stock Exchange (NYSE), the American Stock Exchange (Amex) and the National Association of Securities Dealers (NASD) - to adopt uniform listing standards that were modelled on Rule 19c-4. Soon after that decision, the NYSE put forward a proposed standard which is loosely based on Rule 19c-4 and, at the time of the proposal, SEC's Director of Market Regulation expressed the hope that the other exchanges would follow the NYSE in adopting rules on the lines of Rule 19c-4.[62]

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60. Exchange Act Release No.25891 (July 7, 1988)

61. Business Roundtable v. SEC, 905 F2d 406 (D.C. Cir. 1990)

62. See Sec. Reg. & L. Rep. (BNA) 895-896 (1990)

The proposed standard reads as follows:

> "Voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the Exchange Act cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time-phased voting plans, the adoption of capped voting right plans, the issuance of super-voting stock, or the issuance of stock with voting rights less than the per share voting rights of existing common stock through exchange offer.
> SUPPLEMENTARY MATERIAL: The above restriction against the issuance of super voting stock is primarily intended to apply to the issuance of a new class of stock, and companies with existing dual class capital structure would generally be permitted to issue additional shares of the existing super-voting stock without conflict with the policy."[63]

This standard as proposed by the NYSE, was later adopted by the Amex and the NASD.

E) THE EFFECT OF DISPROPORTIONATE VOTING ON SHAREHOLDERS' RIGHTS

The view has been expressed that corporate members, being an important group in the parties to the corporate contract, should play an important role in the decision-making processes of their companies. By corporate contract is meant the web of quasi-contractual and contractual arrangements which regulate the relationship of the different groups in a company. Shareholders are supposed to be able to resort to the voting process to

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63. New York Stock Exchange Uniform Voting Rights Policy – Request For Comment 1 (Feb. 3, 1994)

remove incumbent management when management performance is unsatisfactory. The voting rights of shareholders should be one of the most significant checks on management with the final effect of moving management to try and achieve the maximum return on shareholders' investment[64].

The view of the law is that shareholders as 'owners' are in a position to exert some control by exercising their voting rights. By stripping shareholders of their voting rights, corporate management could significantly limit the power of shareholders to oversee management and protect their investment[65]. Disproportionate voting rights of shares could result in management securing majority voting rights on all occasions which would enable them to resist any attempts by shareholders to remove them from the board.

The continuing existence of disproportionate voting power, therefore, can create insurmountable obstacles to the ouster of incumbent management and, where new directors are to be appointed, the selection process can be undertaken by management either directly or indirectly without any input

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64. Denham R. E, Envisioning New Relationships Between Corporations and Intelligent Investors, Speech to the Institutional Investor Project Columbia University School of Law Conference on Relational Investing, May 7, 1993.

65. Monk R.A.G. and Minow N, Watching The Watchers, 1996, 198, Blackwell Business, - where they argue that corporate managers often limit shareholders' voting rights thus restricting their voice in corporate governance.

from the shareholders[66]. It therefore becomes obvious that disproportionate voting power of shares is contrary to the notion of corporate democracy.

According to Boone Pickens:

> "equal voting rights and common stock ownership are inextricably linked. Over two hundred years of experience have established equal voting rights as a fundamental tenet of...... democracy."[67]

Like Pickens, others have argued that shareholder participation in corporate decision-making on a one vote per share basis is desirable in itself. It, therefore, becomes important that shareholder participation in the decision-making process be considered a necessity for management efficiency.[68]

It can be argued that the mechanics of achieving a consensus among thousands of shareholders in a large company constitutes an obstacle to active shareholder participation and decision-making. Active participation is also precluded by shareholders' widely divergent interests. As is the case in

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66. Brewster A, Senate Testimony, Subcommittee on Securities, Oct. 17 1991. Also Regan E, U. S Competitiveness: Financial Markets and Corporate Governance, Synopsis of Remarks delivered at the Conference on Global Views on Performance Measurement, Financial Executive Research Fund Dallas, Dec. 16, 1992, pp.4-5

67. Picken, B, American Corporations And Corporate Democracy, 1989, 87

68. Dooley, M. P., Two Models of Corporate Governance, 1992, 47 Bus. Law, 461, 466-467

the U.K., shareholders in the U.S. buy company shares with profit-making as their principal goal and where the performance of their company is not satisfactory, even in the short term, they are likely to sell their shares rather than involve themselves in the detailed affairs of their company.

The "efficient capital market hypothesis" is sometimes said to provide another reason for shareholder's inability to participate in corporate control. If the market is a reliable indicator of performance as the efficient capital market hypothesis claims, investors can easily check the performance of companies in which they hold shares and compare their current holdings with other investment positions. Shareholders find it easier to switch to a new investment than fight the incumbent managers.

Despite the market force, equal voting rights may help to check management by making it accountable for its actions, while disproportionate voting shields management from exposure to the full force of shareholder control. This point was emphasised by the American Securities Exchange Commission during the Rule 19c-4 controversy.[69]

Disproportionate voting rights of shares may be financial disadvantageous to shareholders. Empirical evidence has shown that disparate voting rights of

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69. Exchange Act Release No. 24623 (June 22, 1987), Fed. Sec. Rep. (CCH) 84:143 at 88:773

shares affect shareholder's wealth and the general income paid on their shares since the stock market expects a lower future flow of income from lesser-voting shares.[70] The ordinary share with full voting rights is likely to sell at a higher price than one without voting rights because of the premium that bidders will pay to buy voting control of a target company on a take-over.

Specific studies have found significantly lower prices resulting from disproportionate voting rights of shares.[71] These studies have concluded that shares with superior voting rights do sell at higher prices. In a study which attempted to determine the value of voting in twenty-six companies with two classes of ordinary shares, the class with voting rights traded at a price premium of 5.44%. over and above the other class.[72] A follow-up study found similar premiums in a sample of six private companies with two classes of shares differentiated only by voting rights.[73] The higher dividend that is paid on lesser-voting shares is unlikely to compensate fully for the loss of

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70. Partch, M, The Creation Of A Class Of Limited Voting Common Stock And Shareholder Wealth, 1987, 18 J. Fin. Econ. 313, 314

71. Gordon J. N., Ties That Bond: Dual Class Common Stock And The Problem Of Shareholder Choice, 1988, 76 Cal. L. Rev 1 at 28-29; Also SEC Office of the Chief Economist, Update – The effect Of Dual Class Recapitalizations On Shareholder Wealth: Including Evidence From 1986-1987 (July 1987), 4

72. Lease, McConnell & Mikkelson, The Market Value Of Control In Publicly-Traded Corporations, 1983, 11 J. Fin. Econ. 439, 469

73. Lease, McConnell & Mikkelson, The Market Value Of Differential Voting Rights In Closely Held Corporations 1984, 57 J. Bus. 44

capital and has been viewed as a bribe to get shareholders to vote for proposals they would otherwise reject.[74]

In the U.K. there is evidence that disproportionate voting rights of shares deprive shareholders of liquidity and marketability of their shares. According to Geoffrey Maitland Smith, chairman of Hammerson, one of the U.K.'s international property investment institutions, one of the purposes of equalising the voting rights of ordinary shareholders in that company was to increase the marketability and appeal of the company's shares to the benefit of all shareholders.[75] Similarly Sir Michael Angus, Whitbread chairman, commented that a move to give equal voting rights to all shareholders in Whitbread would provide greater flexibility in addition to providing shareholders with liquidity and marketability of their shares[76].

Under German corporate practice there is also clear evidence that disparate voting right attached to a company's shares has a negative effect on shareholders' investment. A move by RWE, the German industrial conglomerate, to phase out its controversial multiple voting shares which

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74. Exchange Release No. 25981 (July 7, 1988)

75. Taylor P, Hammerson Share Vote Changes, Fin. Times, Oct. 20, 1993, 22

76. Rawstorne P, Whitbread Gives Equal Rights, Fin Times, Oct. 7, 1993, 25

were mainly held by local authorities, is said to have enhanced the attractiveness of the company's shares to investors. The shares jumped from the value of DM 78.5 to DM 87.5 in Frankfurt after the announcement of plans to simplify the share structure of RWE's registered shares from 20 votes each to one vote per share[77].

One is, thus, tempted to suggest that where management of a company with disproportionate voting shares sells a controlling block and receives a premium such a sale should be rigorously reviewed. As early as 1947, the American courts had already moved in this direction. In Zahn v. Transamerica,[78] the Third Circuit allowed a cause of action by holders of Axton-Fisher Class A shares challenging a redemption of the shares before liquidation of the company because the board could not assert a persuasive business reason for the transaction. The practical consequence of the court's decision was that the Class A shareholders were allowed by the court to receive $240 per share from their liquidation rights instead of $80.80 from the redemption of their shares. The court emphasised that:

> "there was no reason for the redemption of the Class A stock to be followed by the liquidation of Axton-Fisher except to enable the Class B stockholders to profit at the expense of the Class A.[79]

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77. Atkins A, RWE Plans Simplified Share Structure: Move Would Phase Out Multiple Voting Rights of Municipal Shareholders, Fin. Times, Aug. 15 1997, 21

78. 162 F 2d 36 (3d Cir. 1947)

79. Ibid at p. 46

In Judah v. Delaware Trust Co. the Supreme court of Delaware, citing Zahn's case with approval, reiterated that:

> "close judicial scrutiny should be given to the actions of management which served to prejudice the interests of subordinate security holders."[80]

Disproportionate voting power of shares constitutes a source of potential conflict between managers' self-interest and the interests of the shareholders. Although directors are fiduciaries who are charged with the duty of acting in the best interest of the 'company as a whole', which includes shareholders' interests, it is clear that whatever the motive behind their issue, disparate voting shares give a certain group voting control.

The fact that management's voting control is not commensurate with the risk it bears may also bring about conflict of interest. As an illustration of the potential conflict between managers' self interest and those of shareholders in a dual class capital structure, the analogy of management leveraged buyouts (MBOs) will be used. In effecting an MBO, management obviously has conflicting interests to those of shareholders. On the one hand they are fiduciaries of the shareholders charged with getting the best price for them. On the other hand, as buyers, they have a strong self-interest in paying the lowest possible price. There is always the temptation for managers to use their voting control to further this self-interest.

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80. 378 A. 2d 624, 628 (Del. 1977)

In situations of disproportionate voting arrangements there is the same potential conflict of interests where management controls the superior voting shares. The temptation for the management team to act in its own self-interest is very strong and, in the event of a proposal to remove one of them from the board, shareholders' efforts are likely to be unsuccessful. The resulting effect is that corporate management has no opposition even though such is vital for the purpose of checks and balances.

F) CONCLUSION

Voting rights which should be a basic, inherent, right of shareholder have not worked as a check on the competence, accountability, and diligence of corporate managers. As Lowenstein rightly observes:

> "what once seemed to be a basic, immutable right, equal voting, has been unbundled from common stock.......[81]

Shareholders should be in a position to monitor the exercise of powers by managers to ensure that their actions are in the interest of investors. With such arrangements as multiple voting rights, non-voting shares, fractional shares and exchange offers, management in U.K. companies are able to protect themselves from removal. Although the London Stock Exchange

81. Lowenstein. L. , Shareholders' Voting Rights: A Response To SEC Rule 19c-4 And To Professor Gilson, 89 Colum. L. Rev. 979

does not regard disproportionate voting arrangements favourably, no positive step has been taken to prohibit these arrangements.

Unlike in the U.K, U.S. courts and Securities Administrative bodies have taken a strict stand on disproportionate voting arrangements especially where enhanced voting is used for the appointment and removal of directors. Although multiple voting is generally prohibited under German law the arrangement of voting by graduation is used. This practice which restricts the voting power of any shareholder to a certain percentage of his total votes constitutes a serious limitation to shareholders' voting rights.

In the three jurisdictions under study there has been one thing in common - a general consensus that the exercise of voting rights by corporate risk bearers is one of the bases of the legitimacy of corporate governance. These systems have recognised that the primary legal weapon of shareholders is the right to vote on their shares in general meetings. Where this right is denied them, shareholders will be unable to monitor corporate managers. Without such oversight of the management team, conflict of interests are likely to arise with a resulting lack of accountability to the members.

Disproportionate voting rights of shares are, therefore, undesirable since they are inconsistent with the principle of corporate democracy and affect the powers of shareholders to appoint and remove directors. Strict legal or exchange rules can, therefore, go a long way in minimising the divergence between the interests of managers, who use this device to entrench themselves, and those of shareholders.

CHAPTER EIGHT

SHAREHOLDERS' VOTING ARRANGEMENTS

A) INTRODUCTION

A shareholders' voting agreement is a contract between some or all the members of a company requiring that they vote on their shares in a particular way on certain defined matters and resolutions. Those matters may include the financing and running of the company, conditions subject to which company properties may be sold, policies on dividend payment and the appointment and removal of directors. The shareholders retain title to their shares and the right to vote on them but are contractually bound to vote according to a pre-arranged plan.

A shareholders' voting agreement is a contract and is enforceable in accordance with normal contractual principles[1]. They can be used to provide some protection to minority shareholders against the principle of majority rule, thus tailoring the corporate structure to fulfil the participants' particular needs.

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1. Puddephatt v. Leith [1916] 1 Ch 200; Stedman G. and Jones J, Shareholders' Agreements, (1998), 3rd ed.,58, Sweet & Maxwell; Comment, Voting Agreement or Voting Trusts? A Quandary For Corporate Control, (1958) 10 Stan. L. Rev. 565

As a voting device shareholders' agreements can be grouped into two main categories. The first category involves two or more shareholders, each owning a minority interest but together controlling a majority of the shares, who agree to cast their votes as a unit on particular matters or for designated candidates to be agreed on by the parties before the appointments. The second type concerns one or more shareholders, often owning a majority interest, effectively giving up some voting strengths to others. This usually takes the form of shareholders agreeing to vote their shares so as to ensure the appointment of a certain person or group of persons, designated by the other party, as director.

A voting trust, on the other hand, is a device, created by the transfer of voting shares by shareholders to trustees (usually other shareholders) who hold and vote on the shares for a term of years or for a period contingent on a certain event, pursuant to a voting trust agreement. In the U.S. case of Peyton v. William C. Peyton Corp.[2], the court defined a voting trust as:

> " A device whereby two or more persons owning stock with voting powers, divorce the voting rights thereof from ownership retaining, to all intents and purposes, the latter in themselves while transferring the former to trustees in whom the voting rights of all the depositors in the trust are pooled."[3]

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2. 22 Del. Ch. 187, 194 A 106

3. Ibid at p.111

The result is that the trustee has legal title to the shares in addition to the right to vote either in the manner agreed on or at the trustee's discretion[4]. The shareholders are usually issued voting trust certificates which carry the right to dividends and other asset distributions. Voting trusts are normally created for the purpose of giving certain shareholders control over major decisions in their companies and a voice in the selection of their directors[5].

Voting trusts are commonly used in the United States but are relatively neglected in the U. K. and Germany. This is evident from the fact that, despite the extensive litigation which has taken place in the United States on the problems caused by the use of voting trusts, there are neither case law authorities nor statutory provisions on this specific issue in the U.K. and Germany.

The question is whether voting arrangements ensure active participation by shareholders in the affairs of their company? This chapter will examine the mechanics of shareholders' voting arrangements to determine whether these devices are used to further or deprive shareholders of any significant role in corporate decision-making and the composition of their board in particular.

4.. Pickering, M., Shareholders' Voting Rights And Company Control, (1965) 81 L.Q.R. 248 at 257

5. Choper, J.H. Coffee, J.C. and Gilson, R.J., Cases and Materials on Corporations, 1995, (4th Ed) 721, Little Brown and Co.

As voting arrangements are unlawful under German law[6] the comparisons in this chapter will be restricted to the positions in the United Kingdom and the Unites States.

B) ARRANGEMENTS UNDER U. K. LAW

1. Shareholders' Voting Agreements

English law has always recognised the right to vote as a right of property. In Northern Counties Securities Ltd v. Jackson and Steeple Ltd[7] Walton J. clearly stated this position thus :

> "When a shareholder is voting for or against a particular resolution ..... he is voting simply in exercise of his own property rights ....."[8]

Shareholders' voting agreements are, however, valid ways by which members can exercise their property rights, and parties to the agreement will be bound by its terms, which will be enforceable in court provided that they do not contravene the general law.

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6. Gorton G. & Schmid F., Universal Banking and the Performance of German Firms, (1996), National Bureau of Economic Research Working Paper 5453, Cambridge: Rajan R, Insiders and Outsiders: The Choice Between Relationship and Arms-Length Debt, 1992, 47 Journal of Finance, 367

7. [1974] 1 W.L.R. 1133

8. See also Pender v. Lushington [1877] 6 Ch. D. 70; Carruth v. Imperial Chemical Industries Ltd [1937] A.C. 707

a. The Validity Of Shareholders' Voting Agreements

Where shareholders contract with the company or with each other in respect of the exercise of their voting rights the courts have often upheld such contracts. In Greenwell v. Porter[9] the plaintiff had purchased shares in a company from executors and the transaction included a provision that the latter should vote for, and not oppose, the re-election of directors appointed by the plaintiff when they retire by rotation. To this effect clause one of the agreement stated :

> "(i) The executors shall take all steps and do all things within their power which may be required for obtaining the election, as directors of Robinson's Brewery Limited, of Aynsley Greenwell and Thomas Trevor White, and shall at all times hereinafter vote for and not against their re-election as director ....."

The agreement extended to shares whether held by the executors in that capacity or in their own personal capacity. On the retirement of one of the directors some of the executors threatened to oppose his re-election. Granting an injunction restraining the executors from voting against the re-election the court stated that clause one of the agreement was valid and had to be upheld. In Puddephatt v. Leith[10] the plaintiff had mortgaged shares in the company to the defendant and transferred them into his name. By a

9. [1902] 1 Ch. 530

10. [1916] 1 Ch. 200

contemporaneous letter, the defendant had undertaken to vote on the shares as directed by the plaintiff. The court issued a mandatory injunction requiring the defendant to comply with the undertaking as agreed.

Voting agreements can be entered into by all or some shareholders of a company to supplement the articles of association. Generally speaking the courts will give effect to an agreement by shareholders to vote in a particular way at general meetings. Parties to the agreement will be bound by the express terms of the contract and additional provisions will not normally be implied. The agreement will impose obligations on the parties to vote in the way stipulated and will normally be strictly enforced by the courts.

Voting agreements are limited to the period of time within which parties to the contract hold their shares and have no binding effect on transferees even if notice was given of their existence. In Greenhalgh v. Mallard[11] the appellant agreed to subscribe for £11,000 worth of debentures in a private company which was in urgent need of money. Some shares were allotted to the appellant and to the three existing directors. A collateral agreement was entered into at the same time between the appellant and the three directors whereby the directors agreed to vote with and support the appellant when required by him to do so. The aim was to give the appellant

11. [1943] 2 All E. R. 234, C.A.

sufficient voting control to enable him to carry an ordinary resolution. This control was lost when the three directors sold all but one hundred of their shares to other members of the company.

The appellant contended that in parting with their shares, the three directors broke their contract by putting it out of their power to support the appellant with the votes necessary to carry an ordinary resolution. The court held that the obligation under the agreement was only to vote in respect of whatever shares the three directors might have from time to time but came to an end when they were sold. According to Lord Greene, M.R:

> "I cannot bring myself to see that this document can be construed as imposing an absolute duty on the owner of the shares not to sell them. An obligation of this kind might have unforeseeable results. ..... a mere undertaking by the shareholder to vote in a particular way, cannot by implication impose upon him a prohibition against the sale of his shares."[12]

This problem can be overcome by inserting a clause which prevents parties to the agreement from selling their shares.

A shareholders' voting agreement is not a constitutional document and so it is not normally subject to alteration by a special resolution, but where a particular majority is stipulated by the agreement itself an alteration has to be effected by the majority specified. Where the parties to the agreement are

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12. Ibid. at p. 240

the company and all its members there might be an express requirement that any person acquiring shares in the company should be required to become a party to the rights and obligations under the agreement. In such cases a shareholders' agreement is similar in effect to the articles of a company. Despite this similarity there are important differences between the two. Firstly, provisions of a shareholders' agreement cannot be altered without the consent of all the parties to it unless the agreement so provides. Secondly, an agreement of this nature creates personal rights which only bind parties to the contract as such.

A shareholders' agreement can be regarded as an informal arrangement, equivalent to a resolution of the members in general meeting[13], if it is in writing and all the members are parties to it.[14] Where there is unanimous agreement between the shareholders to a proposal there can be little objection to treating the agreement as binding. However, case law has gone further to hold that where all the members who are entitled to vote on a particular matter have informally agreed on it or accepted a course of action, the agreement may be treated as a resolution of the company.

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13. In Re George Newman & Co. [1895] 1Ch 674 – the separate, individual consent of shareholders was held to be equivalent to the consent of the general meeting; In Re Gee & Co. (Woolwich) Ltd. [1974] 1 All E.R. 1149 – shareholders' assent to a statute-barred debt was held to be binding on the company.

14. Section 381A, Companies Act 1985 recognises this practice; Also Table A, art 53.

In Cane v. Jones[15] two brothers, Percy and Harold Jones, formed a company in 1946 to run the family business. Each was a director and the shareholding was divided equally between members of Percy's family and Harold's family. The articles gave the chairman a casting vote at both directors' and shareholders' meetings, but Harold's daughter, Mrs Cane, claimed that an agreement had been made between all the shareholders in 1967 which provided that the chairman should cease to be entitled to use his casting vote, so that Percy (who was currently chairman) did not have a decisive vote in the company's affairs. Wheeler Q.C. sitting as a deputy judge of the High Court held that the 1967 agreement, although not drafted as a resolution and not signed by the signatories in each other's presence, represented a meeting of minds of all the shareholders. He emphasised that since this was the essence of a general meeting the agreement was effective to override the articles.[16]

From these cases, it is clear that the courts will accept the agreement of all shareholders as a corporate act in the same manner as a formal resolution[17].

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15. [1981] 1 All E.R. 533

16. Also the case of Re Duomatic Ltd [1969] 2 Ch. 365 at 373 where Buckley J stated:

> " I proceed upon the basis that where it can be shown that all shareholders who have a right to attend and vote at a general meeting of the company assent to some matter which a general meeting of the company could carry into effect, the assent is as binding as a resolution in general meeting would be."

17. Stedman G. and Jones J, Shareholders' Agreements, 1998, 3rd ed, 76, Sweet and Maxwell

Where an agreement constitutes an informal resolution it may not bind third parties[18] although it may bind subsequent transferees of shares.[19]

b) Shareholders' Agreement As Fetters On Statutory Powers

There is now no doubt that shareholders can enter into agreements on how they are to vote in general meetings on specific issues - examples are increasing the share capital and removing a director. The question has been whether such agreements constitute unnecessary fetters on the statutory powers of a company exerciseable by shareholders in general meeting?[20] In the case of Russell v. Northern Bank Development Corporation Ltd and Others[21] the House of Lords, hearing an appeal from the Court of Appeal of Northern Ireland, had to determine the question whether provisions contained in a shareholders' agreement which apparently restricted the exercise of a company's statutory powers were valid. The relevant facts of Russell's case were that the five shareholders in Tyrone Bricks Limited ("T.B.L.") and the

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18. Section 42 of the Companies Act 1985; There is also the issue of registration. An agreement which is the equivalent of a resolution which must be registered must itself be registered at the Companies House.

19. This is unlike a pure shareholder agreement which has no binding effect on transferees - Greenhalgh v. Mallard [1943] 2 All E.R. 234 C.A.

20. Jennifer James, Shareholder Agreement And The Constitution Of The Company, 1992 S.L.R. 10

21. [1992] 1 W.L.R. 588

company entered into an agreement under which each undertook that the terms of the agreement should have precedence, between the shareholders, over the articles of association. Clause 3 of the agreement stated :

> "no further share capital shall be created..... without the written consent of each of the parties hereto."

Some years later the board of T.B.L. gave notice of an extraordinary general meeting at which it was proposed to move a resolution to increase the share capital from £1,000 to £4,000,000.[22] Mr Russell, who was one of the shareholders, applied to the High Court of Northern Ireland for an injunction to restrain the other shareholders from considering or voting on the proposed resolution.

At first instance Murray J. dismissed the action on the ground that the relevant agreement was invalid and ineffective in law as it was an attempt to fetter the company's statutory power to increase its share capital. The High Court's judgement was affirmed by a majority of the Court of Appeal.[23] The decision of the Court of Appeal was reversed by the House of Lords. Upholding the validity of the agreement the House concluded that it was one

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22. Section 121 Companies Act 1985 provides that, if so authorised by its articles, a company may alter the conditions of its memorandum by increasing its share capital. The articles of Tyrone Bricks Limited incorporated Table A Reg. 44 which provides "The company may from time to time by ordinary resolution increase the share capital by such sum, to be divided into shares of such amount, as the resolution should prescribe."

23. Hutton L.C.J., Kelly L.J., and MacDermott L.J. dissenting - [1991] B.C.C. 517.

of a purely personal nature and one which the shareholders were legitimately entitled to enter into. Expressing the unanimous opinion of the House, Lord Jauncey quoted with approval[24] a passage from Lord Davey's judgment in Welton v. Safferey[25] which states:

> "Of course, individual shareholders may deal with their own interests by contract in such a way as they may think fit. But such contracts, whether made by all or some only of the shareholders, would create personal obligations, of an exceptio personalis against themselves only, and would not become a regulation of the company, or be binding on the transferees of the parties to it, or upon new or non-assenting shareholders".[26]

Although these cases are based on the right to alter the share capital and the articles of the company, it is obvious that if the issue was the appointment or removal of directors the reasoning of the House of Lords would have been the same. The effect would be to restrict the general meeting from acting in accordance with its statutory power to remove directors with whom shareholders are not satisfied.

Any resolution to remove directors which is contrary to the terms of the agreement would be defeated unless those party to the agreement expressly gave their written consent to vote in its favour. This intrusion on the

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24. at p.1021

25. [1897] A.C. 299

26. at p.331

company's ability to act in pursuance of a statutory power, even if only of a temporary nature, constitutes a serious distortion of the intention of the law[27]. Emphasising that such obstruction may have the effect of preventing shareholders from exercising their powers Stephen Griffin, referring to Russell's case, states :

> "The House of Lords have surely, in giving full effect to the contractual force of a shareholder agreement, created a monster which should, at the first reasonable opportunity, be slain by legislative reform".[28]

It can rightly be said that the Russell's case upheld devices and private agreements used to circumvent certain provisions of the Companies Act. It is arguable that a member's vote, apart from being personal, is a part of the company machinery and cannot be restricted by contract for the purpose of preventing the application of some provisions of the law. Russell's case, therefore, leaves company law theory at an uncomfortable juncture in the face of mandatory provisions of company law existing side by side with valid private agreements and devices designed to frustrate them. [29]

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27. This constitutes a deprivation of shareholders' individual voting rights and may induce the contracting parties to consider their own interests instead of the interest of the company

28. Griffin S., A Restriction On Statutory Powers, N.L.J. (1993) 589 at 590

29. Shapira G., Voting Agreements And Corporate Statutory Powers, (1993) 109 L.Q.R. 210

2. VOTING TRUST

Voting trusts have been recognised under U.K. law and practice as having three main uses. Firstly, where a company is formed for a purpose which has to be implemented in a particular way, a voting trust can be put in place to ensure that the controllers of the company are persons who will give effect to the purpose of the company in the particular manner expected.[30]

Secondly, it has been argued that the numerous and dispersed shareholders of U.K. public companies would benefit from voting trust arrangements which would enable the trustees to exercise the power of appointing directors on behalf of individual members. In recognition of this use of a voting trust Wheatcroft, as far back as 1950, argued that boards of directors of many large companies are self-perpetuating and that independent trustees should be appointed by shareholders to deal with the appointment and remuneration of corporate managers.[31]

Thirdly, a circumstance where there is potential for conflict of interest and

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30. Re Astor's Settlement Trusts [1952] Ch. 534, where a trust was created to safeguard editorial independence.

31. Wheatcroft, G.S.A., Directors As Trustees, British Management Review, Dec. 1950, (Vol.9), 45 at 48

strife to occur may make the intervention of a trustee an important one. The creation of a voting trust in such a situation would enable the trustee to appoint or supervise the appointment of directors.

On the creation of a voting trust the trustee may have either an absolute or a restricted authority to act on behalf of the shareholder. It is important that the terms of a voting trust be clearly spelt out so that all the parties concerned are aware of their rights and obligations under it. In Butt v. Kelson[32] it was held that where a company's shares are held on trust, the rights of the beneficiaries are derived from the terms of the trust deed and not from the company's regulation.

As long as the trust continues, the trustees have absolute and uncontrolled authority and discretion to vote the shares in the trust. Persons that have put their shares in a voting trust are often referred to as equitable owners of shares. By the trust agreement they become equitable tenants in common in the mass of shares transferred to the trustee, with a contractual right to receive dividends and to retransfer the shares on the termination of the trust.[33]

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32. [1952] Ch. 197

33. Woloszyn, J.J., A Practical Guide To Voting Trusts, (1975) 4 U. Balti. L. Rev. 245

Although a voting trust may be implemented to protect a major creditor of a company, it may also be used to ensure permanency of tenure for a particular group of directors. When used for this purpose this device takes from shareholders their power to make fundamental changes and determine board composition. It, therefore, has a similar effect to non-voting shares as a means of concentrating control in a few hands. In view of the possible abuse of this arrangement, shareholders' voting power should not be treated as an assignable right. It should be exercised by the beneficial owner in the company's interest and not used to protect the interests of outsiders.

C) VOTING ARRANGEMENTS UNDER U. S. LAW

1. Shareholders' Voting Agreements

It is common practice in the U.S. for participants in private companies to enter into agreements among themselves to provide protection to minority shareholders against the principle of majority rule or to tailor the corporate structure to the participants' particular needs.[34] Shareholders' agreements in the U.S. typically cover the selection of members of the board of directors,

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34. Geld, H. Close Corporation Control And The Voting Agreement, (1981), 16 Land & Water L. Rev. 225, at 227-8

the naming of corporate officers and the amount of time each participant is to devote to the company' business.[35]

a. The Stand Of The Early Courts

The early decisions in the United States almost invariably held a challenged voting agreement to be invalid. By looking on shareholder agreements with distrust the courts indicated that there could be no agreement by which the voting right of shares was separated from ownership. The power to vote was treated as inherently annexed to, and inseparable from, the ownership of shares.

In deciding cases, the courts usually laid down broad statements of policy that would invalidate any voting arrangement. In Long Park, Inc. v. Trenton New Brunswick Theatres Company[36] an agreement which entrusted the management of a company to one of three shareholders but provided for a shift to the other two for cause (the cause to be determined by an arbitrator) was held to be void. A New Jersey court in Nickolopoulos v. Sarantis,[37]

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35. Non-management matters may also be included in shareholders' voting agreements, examples are method of resolving disputes that may arise among the participants and re-purchase of shares by the company on a shareholder's death.

36. (1948) 297 N.Y. 174, 77 N.E. 2d 633

37. (1928) 141 A. 792 N.Y.

refused to enforce a unanimous shareholders' agreement under which a 25 per cent shareholder was given a 50 per cent vote.

A Georgia court in Morel v. Hoge[38] held void an agreement giving the holder of 50 per cent of the company's shares the right indefinitely to name three of five directors.[39] In D'Arcangelo v. D'Arcangelo[40] it was held that in the absence of statutory provision it was unlawful and a gross violation of public policy to permit or contract for the separation of voting power from share ownership. The court in the North Carolina case of Sheppard v. Rocking Power Co.[41] held a ten-year voting pool and trust to be void as separating voting power from ownership.

In such cases shareholders were considered to have contracted for each other's independent advice and judgement at shareholder's meetings. Each shareholder, therefore, owed his fellow shareholders a duty to vote his shares in the best interests of the company, and the other shareholders were thought to have a right to insist on the exercise of his independent judgement in casting the votes.[42]

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38. 61 S.E. 487 (Ga. 1908)

39. Also Benintendi v. Kenton Hotel, Inc.,(N.Y. 1945) 60 N.E. 2d 829 - where the court invalidated a bylaw requiring a unanimous vote of shareholders to appoint directors

40. 137 N J Eq 63, 43 A2d 169

41. 150 N C 776, 64 Se 894

42. Hodge O'Neal H., Close Corporations, 5.04, 1988, (3rd Ed.)

b. Validity Under Statutory Law

Most modern state statutes in the U.S. have now validated shareholders' agreements which bind the parties, as shareholders, in the absence of fraud on the minority or other illegal object, and have declared them enforceable.

After the inclusion of such provisions on shareholders' voting agreements in the Corporation Laws of different states the courts, especially those in New York, have indicated some changes in judicial thinking on their validity. The first state statute to provide for voting agreements was the North Carolina Business Corporation Act 1955 of which the relevant provision reads :

> "Contracts between two or more shareholders that the shares held by them shall be voted as a unit for the election of directors shall, if in writing and signed by the parties thereto, be valid and enforceable as between the parties ....."[43]

The relevant provision of the New York Business Corporation Law that first regulated shareholders' agreement - Section 620(a) provides :

> "An agreement between two or more shareholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as therein provided ....."[44]

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43. S.55-72 North Carolina Business Corporation Act 1955

44. S.620(a) New York Business Corporation Law 1961

The provision on shareholder agreement in the Delaware General Corporation Law has been the most elaborate. The most recent version require such agreements to be in writing, signed by the contracting parties and should not be for a term exceeding ten years"[45]

The Delaware provision on shareholders' agreements has been adopted in the Corporation Laws of most States.[46] The 1969 Model Business Corporation Act provides that agreements among shareholders regarding the voting of their shares shall be valid and enforceable in accordance with their terms.[47]

Some cases have, in the light of these statutory provisions, held that it is not a violation of shareholders' rights to cause their company's affairs to be managed in such a way as they may think best for the purpose of furthering the ends of the company if it does not infringe the statutory norm. Shareholders can, on that basis, combine their votes or agree on how to vote

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45 Section 218(c) of the Delaware General Corporation Law 1994

46. Examples of this are Ss.158 and 300 Cal. Corp. Code 1990; S.10-2A-307 Ala. Code 1987; Ss.342, 350 and 354; S.5/2 A45 Ch. 805 Ill. Ann. Stat. 1993; Ss.2331-2332 15 Pd. Cons. Stat. Ann. 1994

47. Section 34 Model Business Corporation Act Ann, 1969, (3rd Ed.).

for the appointment of directors so as to secure or retain the control of the company,[48]

In Matter of Glekel (Gluck),[49] an agreement between the seller and buyer of shares stated that if the directors designated by the buyer were elected, the shareholders were to use their best efforts to cause the company to qualify the seller's remaining shares for public sale. This was held valid since it did not impinge on shareholders' discretion to either sell off or keep their shares[50].

Where a shareholders' agreement constitutes an infringement of shareholders' rights it is likely to be rendered invalid. In Morgenstern v. Cohon[51] the court held illegal an agreement to indemnify persons for loss on resale of shares purchased by other persons in order to vote for the re-election of directors.[52] In Leventhal v. Atlantic Financed Corp.,[53] a

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48. This was upheld in the Texas case of Irwin v. Prestressed Structures, Inc. 420 S.W. 2d 491 (Tex. Civ. App.); Also the New York case of Petition of Rokeach and Sons, Inc., 142 N.Y.S. 2d 460 (Misc

49. 30 N. Y 2d 93, 330 N.Y.S. 2d 371, 281 N.E. 2d 171 (1972)

50. See also Fromlin v. Merrall Realty, Inc. 30 Misc 2d 288, 215 NYS 2d 525

51. 2 N.Y. 2d 302, 160 N.Y.S. 2d 633, 141 N.E. 314 (1977)

52. Section 609 of the New York Business Corporation Law 1990 prohibits shareholders from selling their votes or issuing proxies for any sum of money.

53. 316 Mass. 194, 55 N.E. 2d 20 154 A.L.R. 260 (1975)

shareholders' agreement between two shareholders for dissolution in the event of stated contingencies, and prohibiting parties from otherwise causing dissolution, was held to be violating the shareholders' statutory right to file a petition for dissolution.[54] An oral promise by one shareholder to vote his or her shares to keep a particular person on the board of directors will be unenforceable if the statute requires a voting agreement to be in writing.[55]

Generally speaking valid agreements between shareholders are specifically enforceable because of the difficulties in calculating monetary damages flowing from a loss or dilution of control cause by shareholders' failure to vote their shares as agreed. The problem of enforcement was illustrated in Ringling Bros.-Barnum & Bailey Combined Shows Inc v. Ringling,[56] where the Delaware Supreme Court upheld a voting agreement and ordered that it be specifically enforced. According to that court:

> "A shareholder may exercise discretion in judgement in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow stockholders."[57]

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54. Also Apfelbaum v. American Binder Co., 10 Misc 2d 899, 173 N.Y.S. 2d 753 (Sup. Ct. 1958)

55. Sanders v. McMullen 868 F2d 1462 (CA5 1989)

56. 53 A.2d 441 (Del Sup. Ct 1947)

57. At p. 478

c. Agreements Which Limit Directors' Actions

Shareholders agreements often have provisions which deal with matters which are within management functions of the board. Where an agreement among shareholders contains provisions which tend to limit the discretion of the board of directors in managing the company in its best interest such provisions are likely to be invalid. Examples are provisions in agreements between shareholders which govern the appointment of officers, or how much they are to be paid, or when and in what proportions profits are to be divided. Such provisions violate the statutory rule that the business and affairs of a company shall be managed by or under the authority of the board of directors.[58]

A leading case on this point is Manson v. Curtis[59] which is significant for holding that directors may not, by agreement entered into as shareholders, abrogate their independent judgement. It involved an agreement entered into by the majority of the shareholders which provided that each shareholder was to name three directors. One of the parties, the plaintiff, was to continue in the position of general manager for a year and, as such, was to manage the business of the company and shape its policy while

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58. See Section 27, ch.23 Gen. Corp. Law, Cons. Laws

59. 223 N.Y. 313,119 N.E. 559 (1918)

the president was to remain the only nominal head. The court found the agreement invalid on the ground that its fundamental and dominant purpose was to vest management solely and exclusively in the plaintiff. This was held to have deprived the board of the discretion to select the management team.

In McQuade v. Stoneham[60] three shareholders of a company that owned the New York Giants baseball team agreed as shareholders to elect themselves as directors and agreed as directors to appoint themselves as officers at specified salaries. The New York Court of Appeals held that the provision restricted directorial discretion and rendered the entire agreement invalid. According to the court:

> " the theory that directors exercise in all matters an independent judgement in practice often yields to the fact that the choice of directors lies with the majority stockholders and thus gives the stockholders a very effective control of actions by the board of directors. In truth the board of directors may check the arbitrary will of those who would otherwise completely control the corporation, but cannot indefinitely thwart their will. A contract which destroys this check contravenes charter and statutory provisions and is therefore illegal."[61]

An agreement between shareholders which purports to control the actions of directors in handling the ordinary business of the company will therefore be void. For this reason in Fells v. Katz,[62] the court refused to enforce a

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60. 263 N.Y. 323, 189 N.E. 234 (1934)

61. at p. 265

62. 175 N.E. 516 (N.Y. 1931)

shareholders' agreement which provided that a designated person would serve as president of the company for ten years and not be subject to removal by the board.

From these different cases a general conclusion can be drawn that under U.S. law agreements by shareholders which, in the absence of fraud on the minority or other illegal object, do not infringe the statutory rights of shareholders are valid. Agreements which deprive members of their statutory rights, even when the majority of the shareholders are parties to it, are invalid on the grounds of public policy. A completely different view is taken in the U.K. where the courts have been consistent in giving effect to agreements entered into by shareholders. The general view has been that shareholders are under no fiduciary duties and what they may do individually they may do collectively[63] but the question is whether a lesson can be learnt from the attitude of the U.S. courts.

2. VOTING TRUSTS

Creditors, shareholders and other security holders of a financially unstable company may require that they be given control through the mechanism of a voting trust. Providers of capital would normally use a voting trust to ensure themselves control of or at least a voice in the selection of new management

63. Supra at notes 9-11

or ensure that a company's successful management continues. The voting trust was invented to enable the trustees to vote as owners rather than as mere agents.[64] It is, however, arguable whether voting power can be regarded as an assignable right rather than a privilege which should be exercised for the protection of the interest of the beneficial owners of shares.

a. The Common Law Position

At common law in the U.S. there was a debate as to whether voting trusts were to be regarded as illegal on the ground that the separation of voting power from ownership of shares was in itself against public policy.[65] The practice of the court was to scrutinise their purposes and they would frequently hold them to be against public policy. Because of the potential abuse of this device the U.S. courts would invalidate any arrangement which aimed at securing permanency of a particular management team on the board[66]. In Re Pittocks Will[67] a voting trust agreement entered into by the buyers and sellers of shares, whereby the sellers were to retain voting control

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64. Henry W. Ballantine, Voting Trusts, Their Abuses and Regulations, 21 Tex. L. Tev. 139 (1942)

65. Tracey v. Franklin, 31 Del. Ch. 477, 67 A. 2d 56, 11 A,L.R. 2d 990; People ex rel. Malcom v. Lake Sand Corp., 251 Ill. App. 499; Steele v. Farmers & Merchants Mut. Tel. Assn., 95 Kan. 580, 148 P. 661; Miller v. Farmers Milling & Elevator Co., 78 Neb. 441, 110 N.W. 995.

66. Adams v. Clearance Corp, 35 Del. Ch. 459, 121 A2d 302; Also Watts v. Des Moines Regiter and Tribune, 525 F Supp. 1311 (S.D. Iowa).

67. 102 Ore. 159, 199 Pac. 633 (1921)

indefinitely even after disposing of substantial parts of their shares to the buyers, was held to be unenforceable.[68]

Endorsing this common law view the court in Warren v. Pim[69] vigorously maintained that a voting trust is :

> "a masterpiece of professional ingenuity, which confers absolute and uncontrolled discretion to a group ..... whose personal stake in the success of the company is so insignificant that it may be disregarded entirely; ..... which leaves them free from responsibility for their own mistakes, oversights, forgetfulness or want of prudence, and unhampered by any duty even to supervise the proceedings of their own appointees."[70]

The powers of a trustee are normally set out by contract and depend on the terms of the trust agreement. Where the trust agreement is silent or unclear, the courts will impose equitable limitations on the trustee's power to take actions that might damage the company's business. In Brown v. McLanahan,[71] the court ruled that a trustee could not amend the charter to give voting rights to debenture holders with the result that power was shifted

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68. Also Bostwick v. Chapman, 60 Conn. 553, 24 AtL. 32 (1890), where a voting trust entered into by some shareholders to gain some advantages for themselves which were unfair to the non-party shareholders was held to be against public policy and invalid.

69. 59 A. 773, (N.J. 1904)

70. at p. 781

71.148 F. 2d 703 ((4th Cir. 1945)

away from the trust beneficiaries.

b. Statutory Regulation Of Voting Trust

Voting trusts are now provided for statutorily in all but one state of the United States.[72] The 1969 Model Business Corporation Act provides that any number of shareholders of a company may create a voting trust for conferring on the trustees voting power for a period of not more than ten years.[73] One of the most elaborate provisions on voting trust has been Section 218 of the Delaware General Corporation Law (1994) which provides:

> " a) One stockholder or more may by agreement in writing deposit capital stock of an original issue with or transfer capital stock to any person or persons, or corporation or corporations authorized to act as trustee, for the purpose of vesting in such person or persons, corporation or corporations, who may be designated voting trustee or trustees, the right to vote thereon for any period of time determined by such agreement, upon the terms and conditions stated in such agreement.
>
> b) Any amendment to a voting trust agreement shall be made by written agreement, a copy of which shall be filed in the registered office of the corporation."

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72. Only in Massachusetts is voting trust not provided for under Statute. Despite that, even Massachusetts provides that its voting agreement statute does not invalidate any voting trust that is not otherwise illegal - S.41A Mass. Gen. Law Ch. 156B 1991

73. Section 34 Model Business Corporation Act 1969

When shares which are subject to a voting trust are transferred to a trustee, trust certificates are to be issued to the owners of the shares. The 1969 Model Act requires the trustees to maintain a written record of the holders of voting trust certificates evidencing a beneficial interest in the voting trust and giving the names and addresses of all such holders as well as the number and class of the shares in respect of which the voting trust certificates are held. Some voting trusts operate in a way that the legal title in the shares remain in the share owners with the trustees exercising the voting rights of the shares. Simply depositing shares in a pool is sufficient to bring a shareholder into a trust agreement making him bound by the agreement even when he has not signed it.[74]

A voting trust, therefore, involves a more complete and formal surrender of shareholders' legal rights than any other control device. It's procedure commonly requires that a formal agreement be signed by the shareholders creating the trust, and that a copy of the agreement be filed at the company's principal office.[75] Failure to comply with these provisions at one time led to

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74. In Haines v. Kinderhook Ry. Co., 33 App. Div. 154, 53 N.Y.S. 368, a voting trust which was created in favour of a reorganisation committee was for a period of five years. It was held to be binding on all those who had handed their shares over to the committee even though they had not signed an agreement.

75. Section 34 Model Business Corporation Act 1969; S.7 30 Revised Model Business Corporation Act 1984; S.706, 711 Cal. Corp. Code (1990); S.218(a) and (b) Del. Code Ann. tit. 8 (1991); and S.621 N.Y. Business Corporation Law (1986)

the arrangement being invalid.[76] More recent decisions have, however, upheld such arrangements even when there has been less than literal compliance with the provisions of the statute.[77] Persons who have put their shares in a voting trust become equitable tenants in common of the shares transferred to the trustees, with a contractual right to receive dividends and acquire their shares back on the termination of the trust.

c. Renewal Of Voting Trust

A majority of states expressly permit extensions or renewals of voting trust agreements beyond the original term if the parties so agree within a certain

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76. In Abercombrie v. Davies, 130 A. 2d 338 (Del. 1951) a group of shareholders together holding a majority of shares, agreed that eight designated agents would vote their shares under a proxy granted for ten years. Voting was to be determined by the agreement of seven of the agents or, if seven could not agree, by an arbitration. To enforce the agreement the parties endorsed their share certificates and deposited them with the agents. The court held that the agreement was a voting trust because
1) it separated ownership and voting
2) it transfered voting power irrevocably for a definite period, and
3) its principal purpose was to provide for voting control of the company. As a voting trust, it was invalid for not complying with statutory requirements.

77. In Reserve Life Ins. Co. v. Provident Life Ins. Co. 499 F2d 715 (8th Cir. 1974) a voting trust was held to be valid even though the trustee's address was omitted in the agreement. In State v. Keystone Life Ins. Co., 93 So.2d 565 (La 1976) the court upheld a voting trust agreement even though the statutory requirement was not fulfilled as it had not been signed by all the parties.

length of time before its expiration.[78] The 1984 Revised Model Business Corporation Act authorises extensions of not more than ten years each by signing an extension agreement and obtaining the parties' written consent to the extension. The trustee is required to deliver copies of the extension agreement and the list of beneficial owners to the company.[79]

Under the Revised Model Act, shareholders who do not agree to an extension are entitled to the return of their shares upon the expiration of the original term. A voting trust agreement which gives the trustee the power, at the end of the trust, to make a new voting trust for a further term is invalid.[80] An extension of a voting trust agreement is required to be executed in conformity with statutory provisions.[81]

d. Revocation Or Termination Of A Voting Trust

Where a voting trust is to be revoked or terminated all parties to it are required to give their consent. A trust agreement by one person to a trustee

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78. Under S.706(b) Cal. Corp. Code 1990 a voting trust can be made for a ten-year period plus one further ten-year extension; Also S.218(b) Del. Code Ann. tit. 8 1991; S.621 N.Y. Bus. Corp. Law 1986;

79. S.7.30(c) Revised Model Business Corporation Act (1984).

80. In the New York case of Gertenbach v. Rodnon, 171 Mis. 302, 12 N.Y.S. 2d 518, a voting trust agreement which automatically extended the terms of the original trust without the consent of beneficial holders was held to be invalid; Also upheld in the Delaware case of Adams v. Clearance Corp., 35 Del. Ch. 318, 116 A2d 893

81. See Foye v. New York University 269 A2d 63 (Del.)

for a third person is revocable by the creator at any time before it is communicated to the beneficiary. A statutory voting trust, if valid, is irrevocable for the duration of the trust.[82] Most States incorporate a maximum initial duration of ten years with the possibility of extension for a further period of ten years. In the rare case of a voting trust not being formed under a statute it would depend on the general common law and the terms of the trust. Such agreements, if coupled with an interest, have generally been sustained as irrevocable but where they are not coupled with an interest they are regarded as conveying a revocable power.[83]

A voting trust, like any other trust may be terminated by a court of equity when its purposes have become frustrated or impossible of accomplishment.[84] The courts may, after declaring particular trust agreements invalid or against public policy, declare that the shareholders can revoke the agreement and demand back their shares.[85]

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82. In re Morse, 247 N.Y. 290, 160 N.E. 374, the New York Court of Appeal held that a voting trust agreement confers on trustees the right to vote the shares transferred to them for the duration of the period of the trust.

83. See Boyer v. Newbitt 227 Pa 398, 76 A 103

84. In Griffith v. Jewett, 9 Ohio Dec. Reprint 627, 15 Cin. Wkly L Bull 419, 19 Abb N. Cas. 457, a demand to vote according to the direction of certain persons as provided by the trust instrument was refused by the trustee. This was held to be enough ground for the shareholders involved to terminate the agreement.

85. Luthy v. Ream, 270 Ill. 170, 110 N.E. 373; See also Sheppard v. Rockingham Power Co., 150 N.C. 776, 64 S.E. 894

D) CONCLUSION

It has been recognised that voting arrangements may work to the benefit of minority holders by giving them a say in the control of their company. On the other hand they may provide means by which the power to control and direct the affairs and policies of a company are perpetuated indefinitely. This would defeat the contention that the holders of a majority of shares in a company should have the right to determine the composition of their board of directors.

The party that benefits from the agreement will have voting control of the shares in the instances when they directs the other parties on how they should vote, making them bound by his direction. When considered in this light voting arrangements are at variance with the common law position whereby a shareholder's vote is regarded as a right of property which may be exercised as the shareholder pleases and according to his own wishes and private interests[86].

This was the basis on which older cases in the U.S. held shareholder agreements unlawful since they limited in advance shareholders' discretion to

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86. Pender v. Lushington (1877) 6 Ch. D. 70 at 75. In North West Transportation Co. v. Beatty (1887) 12 A.C. 589 it was held that a member cannot be prevented from voting as he wishes in respect of any resolution by reason of his having a particular interest in its subject-matter.

vote their shares in the best interest of the company thus separating individual judgement from voting rights. The courts, at the time, insisted that voting rights could not be irrevocably separated from ownership of shares. They regarded shareholders' right to vote in accordance with their individual judgement and assessment as being inherently annexed to, and inseparable from, the ownership of the shares. Their present attitude is to take a case-by case scrutiny of matters involving shareholders' voting arrangement.

A different view is taken in the U. K. where the courts have always given effect to shareholders' agreements contending that shareholders are under no fiduciary duties and what they may do individually they may do collectively. Unlike in the U.S, shareholders are not seen as owing their fellow shareholders a duty to vote their shares in what they conceive to be the best interests of the company, by exercising an independent judgement in casting the vote.

In the U.K. there has been no attempt at scrutinising such agreement for purposes of determining their effect on non-contracting shareholders. Voting agreements which are injurious to such shareholders or have the potential of operating as a fraud on them or contain any irregularities should be made void as contrary to public policy. Apart from this, statutory regulation along the lines of those in the U.S.[87] would also be useful in the U.K.

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87. A good example is Section 218(c), Delaware Gen. Corp. Law 1994 which requires such agreements to be in writing, signed by the contracting parties and limited to a term of ten years.

CHAPTER NINE

INTERLOCKING DIRECTORATES

A) INTRODUCTION

In the absence of any agreement to the contrary, nothing prevents a director from placing the experience and skills acquired in the course of employment in one company at the service of another company, with the result that interlocks are created. An interlock exists when one individual sits on the board of two or more companies, with a resulting link being created between the different companies. Brandeis has defined interlocking directorates as :

> "men holding the inconsistent position of director in two potentially competing corporations, even if those corporations do not actually deal with each other."[1]

Two different types of interlocks have been identified, namely direct and indirect. A direct interlock exists where one individual is a director of two or more companies. It will be deemed indirect interlock where two directors, each from a different company, sit on the board of a third company.[2]

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1. Brandeis L, Breaking The Money Trusts, Harpers Weekly, Dec. 6 1913, p.13

2. Herman, E. S., Corporate Control, Corporate Power, 1981, 197, Cambridge University Press; Caswell J. A, An Institutional Perspective On Corporate Control And The Network Of Interlocking Directorates, 1984, Journal of Economic Issues vol. XVIII No 2 pp 68-71

Interlocking directorates, thus, affect the relationships between companies by linking them up through board membership which can be used to facilitate interactions between boards. This makes interlocking directorates of practical significance.

A company can certainly derive considerable advantage from the appointment of experienced individuals with intimate knowledge of the company's area of business, who also hold a number of other directorships. In today's business world the complexity of modern business demands that every effort be made to utilise the skills and abilities of those who have expert knowledge. The presence of such individuals on the boards of several companies may work to the benefit of all parties involved. Two of the main arguments in favour of interlocking directorates have been that they allow a free flow of talents and are a good means of exchanging information without which modern business would suffer.[3]

It is, nevertheless, important to bear in mind the risks attendant on the holding of multiple directorships. A person who sits on several boards may

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3. Mariolis P, Interlocking Directorates And Control of Corporations: The Theory Of Bank Control. 1975 Soc. Sci. Quart. 425

be faced with a number of competing demands by the different companies. This situation is bound to place a director in a difficult position since the director, as a corporate fiduciary, would owe a duty of loyalty to each of the companies.

The potential problems of interlocking directorates was given early recognition by Brandeis (later Supreme Court Justice of the United States), one of the most outspoken critics of this network. According to him:

> "The practice of interlocking directorates is the root of many evils. It offends laws human and divine. Applied to rival corporations, it tends to the suppression of competition and violation of the Sherman law. Applied to corporations which deal with each other, it tends to disloyalty and to violation of the fundamental law that no man can serve two masters. In either event it leads to inefficiency; for it removes incentive and destroys soundness of judgement. It is undemocratic, for it rejects the platform : 'A fair field and no favours,' - substituting the pull of privilege for the push of mankind."[4]

This was re-iterated by the U.S. Senate Committee on Governmental Affairs thus:

> " Personal interlock between business leaders may lead to a concentration of economic and or fiscal control in few hands. There is in this the danger of a business elite, an ingrown group, imperious to outside force, intolerant to dissent and protective of the status quo, charting the direction of industry."[5]

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4. Brandeis L, Other People's Money, 1933, 33, Foundation Press,

5. Senate Committee on Governmental Affairs, Subcomm. On Reports, Accounting And Management, Interlocking Directorates Among The Major U.S. Corporations, Document No. 107, 95th Cong. 2d Sess (1978)

This chapter focuses on the implications of interlocking directorates on shareholders' right and ability to control their company through the appointment and removal of directors. It examines the questions whether interlocks affect directors' ability to represent shareholders' interests on the board or subordinates the interest of some companies on whose boards the directors sit to those of others.

B) INTERLOCKING DIRECTORATES UNDER U.K. LAW

The position under U.K. law is that every director has a fiduciary duty to act so as to promote the best interests of the company.[6] Shareholders therefore appoint directors whom they feel will fulfil the goals of the company. A director is, as a result, not allowed to enter into arrangements or engagements which can result in a conflict of his personal interests and those of his company.[7]

There are five main situations in which interlocking directorships may arise.

a) Where an executive director of a large public company is appointed a non-executive director of another company because of his reputation.

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6. In Re Smith and Fawcett Ltd [1942] Ch. 304 at 304 Lord Greene M.R. clearly stated that directors "must exercise their discretion bona fide in what they consider .... is in the interest of the company and not for any collateral purpose."

7. Aberdeen Rail Co. v. Blaikie Brothers [1843-60] All ER 249

b) Where an executive director is under a service contract which requires him to serve on the board of a subsidiary company.

c) Where an individual with experience in corporate management is appointed to a series of non-executive posts to contribute his experiences to board deliberations.

d) Where a representative of a lending institution is appointed to various boards to protect his employer's interests.

e) Where a person is appointed to various boards in a group of companies at the request of a particular group of shareholders.[8]

Whatever the situation that brings about multiple directorship, the legal position of those so appointed is that they are required to act in the best interests of each company to which they have been appointed. Clearly the existence of interlocking directorates is likely to affect the independence of directors' decision-making and their protection of shareholders' interests. With the typical profile of non-executive directors showing that the majority of them are themselves executive directors in other companies, the question is whether interlocking directorates should be generally controlled by the law.[9]

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8. Butterworths Company Law Service, Issue 65, Aug. 1998 at E68, Butterworths

9. Davis, E. and Kay, J. Corporate Governance, Take-Overs And The Role Of The Non-Executive Directors, in Bishop and Kay (eds), European Mergers and Merger Policy, (1993), 212, Oxford University Press.

Ezzamell and Watson have observed that

> " ....being executives themselves and business acquaintances of the executive members of the board, they (non-executives) can hardly be expected to be independent of the executives that appointed them. Clearly then whatever their specific skills and value as advisers, affiliated non-executives cannot be expected to perform the primary monitoring and control role required to protect shareholders, interests."[10]

It is, therefore unreasonable to expect non-executives to be independent monitors on shareholders' behalf if they themselves are close acquaintances of the executive directors. A survey by PA Consulting and Sundridge Park cited by Bell has shown that 70 per cent of non-executives were either the executives of other companies or personal acquaintances of the company's chairman.[11] A study by Hemmington-Scott of 1,612 U.K. listed companies also found that the majority of non-executive directors were in fact executives of other listed companies.[12]

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10. Ezzamel M. & Watson R., Wearing two Hats: The Conflicting Control And Management Roles of Non-Executive Directors, in Keasey, Thompson and Wright, Corporate Governance: Economic, Management & Financial Issues, 1997, 63, Oxford University Press 63

11. Bell, D. Setting Pay At The Top, 1994, 5-16 Focus Report, Income Data Services .

12. Hemmington-Scott, Non-Executive Director Statistics, 1992, Corporate Register, 5-9, (Hemmington-Scott), An earlier study by Cosh and Hughes had made similar findings – Cosh A. and Hughes A., the Anatomy of Corporate Control: Directors, Shareholders and Executive Remuneration of Giant U.S. and U.K. Corporations, 11 Cambridge Journal of Economics, 285-313..

1. Case Law Approval Of Interlocking Directorships

The issue of interlocking directorates went before an English court in London And Mashonaland Exploration Company Ltd. v. New Mashonaland Exploration Company Ltd.[13] The plaintiff company appointed Lord Mayo as director and chairman of its board. Later the prospectus of the defendant company was circulated with the name of Lord Mayo at the head of the list of directors. It was admitted that Lord Mayo had not objected to becoming a director of a competing company.

The court did not think it necessary to prohibit him from sitting on the board of more than one company. Chitty J., in this case, upholding multiple directorates in such rival companies stated that they were subject to three qualifications. According to him :

(a) A company can, through its articles of association restrict the activities of its directors by requiring a director to give the whole of his time to the business of the company thus prohibiting him from acting as a director of another company.

(b) Where a separate contract, either express or implied, between a director and a company limits a director's activities and requires

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13. [1891] WN 165

him to give his personal services to a particular company and not to any other company.

(c) Where there is evidence or a real fear of disclosure by the director of important confidential corporate information which had been obtained in his position as director of the rival company.

Chitty J. finally decided that, subject to these qualifications, it is permissible for a director of one company to act as a director of a competing company and directors should not be restrained from so acting.

In Bell v. Lever Brothers Ltd [14] the principle was extended so as to allow a director to do for himself that which can be done for a rival company. Lord Blanesburgh, giving approval to Chitty J's view in the Mashonaland's case, observed, in relation to the position of the appellants as directors of the respondent company's subsidiary, that they were under no obligation to refrain from dealing in the same commodities as their company. On the authorities of London and Mashonaland Exploration Co Ltd v. New Mashonaland Exploration Co Ltd and Bell v. Lever Brothers Ltd there is no general prohibition against a director competing with his own company, whether on his own account or by virtue of being a director of another

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14. [1932] AC 161 at pp 195-6

company in the same field of business. These cases fail to recognise that a director occupies a unique position and they should make independent and unbiased corporate decisions while sitting on the board.

2. Analogous Situations

Despite the decisions in these two cases it is obvious that a situation where a director carries out or is associated with a business which competes with that of his company is one which is likely to give rise to a conflict of the directors duty and interest. A director is clearly a fiduciary of his or her company and the position is certainly that, without the consent of the beneficiary, a fiduciary is precluded from competing with the beneficiary. This is the case in the analogous field of partnership law. In the context of partnership the courts have condemned conflict of interests where a fiduciary is concerned. In Aas v. Benham[15] Lindley L.J., succinctly stating the position of a partner as a fiduciary, said :

> "if a partner without the consent of his co-partners carries on business of the same nature as, and competing with that of the firm, he must account for and pay over to the firm all profits made by him in that business ...."[16]

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15. [1891] 2 Ch. 244

16. at p. 255

It is often stated that directors are trustees of their companies on the basis that they occupy a fiduciary position in relation to those companies. In law the duties of good faith which this fiduciary relationship imposes on directors are virtually identical with those imposed on trustees. In York and North Midland Railway Co. v. Hudson,[17] Lord Romily indicated that :

> "....directors are persons selected to manage the affairs of the company for the benefit of the shareholders; it is an office of trust which if they undertake it is their duty to perform fully and entirely."[18]

The position is that trustees as fiduciaries must avoid situations where there is a conflict of interest and duty to the principal. This issue was before the court in Boardman v. Phipps,[19] where the House of Lords held that profits which were made from occupying a position of a fiduciary character should be accounted over. Although not a company law case, Boardman v. Phipps is of interest as it is an application of the rule that a person in a fiduciary position should not put himself in a situation where there is potential conflict between his interest and his duty.

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17. 16 Beav. 485, 491

18. At p. 491; Also in re Forest of Dean Coal Mining Co. 10 Ch. D. 451 at 453, Jessel, M.R. had stated this same point when he said that directors are trustees of corporate properties. See also re Faure Electric Accumulator Co. (1889) 40 Ch D. 141

19. [1967] 2 AC 46 at 123

In Re Thomson,[20] the testator, a yacht broker, directed his executors and trustees to carry on his business after his death. When he died, one of his trustees took a lease of the premises, was about to commence a business in competition with that of the testator's and was challenged by a beneficiary under the will. Holding that the trustee was in breach of his fiduciary duty towards the beneficiary Clauson J. stated :

> "The rule of universal application is that an executor and trustee having duties to discharge of a fiduciary nature towards the beneficiaries under a will, ... shall not be allowed to enter into any engagement in which he has or can have a personal interest conflicting,...with the interests of those, whom he is bound to protect."[21]

Given that company law imposes a strict no-conflict rule on directors[22] it is surprising that multiple directorates are permitted in the same industry under U. K. law. It is, however, likely that the courts would, in some circumstances, regard the actions of a director in one company, because of his duty to another company, as giving grounds for an allegation of unfairly prejudicial conduct in the way in which a company is being run.[23]

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20 [1930] 1 Ch. 203

21. at p. 215

22. This rule was firmly stated by Lord Cranworth LC in Aberdeen Railway Co. v. Blaike Bros. [1843-60] All E. R. 249 at 252

23. Section 459 of the Companies Act 1985 (as amended by Sch. 19, C.A. 1989) which gives a member the right to petition the court where a company's affairs are being or have been conducted in an unfairly prejudicial manner to the interests of its members in general or some part of the members including the petitioner.

In Scottish Co-operative Wholesale Society Ltd v. Meyer,[24] a company was formed by the appellant society and the respondents, Meyer and Lucas, to manufacture rayon cloth subject to obtaining state licensing. The society held the majority of its shares and appointed three of its own directors to the board. The respondents filled the two remaining seats and were joint managing directors. After licensing ceased, the society transferred the company's business to another branch of its organisation, thus causing its activities to stop.

The respondents petitioned for relief under section 210 of the 1948 Companies Act the predecessor to section 459 of the Companies Act 1985 . Ordering that the company should purchase the respondents' shares at a fair price, Lord Denning commented on the potential conflict of interests in such a situation. According to him, by appointing three of its directors to the board of the textile company,

> " these three gentlemen could not do their duty by both companies.......They put their duty to the co-operative society above their duty to the textile company in this sense, at least, that they did nothing to defend the interests of the textile company against the conduct of the co-operative society."[25]

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24. [1959] AC 324

25. At p. 331

3. Conflict Of Interests And Disclosure Of Confidential Information

Shareholders entrust their investment in corporate business to the management of the board of directors. If director A is instrumental in making a contract on behalf of company X, on whose board he sits, with company Y, on whose board he also sits, there is a dual agency. As he owes an equal duty of loyalty to both companies there is likely to be divided allegiance and a conflict of interest and duty to one of these companies.[26]

Although the principle stated by Chitty, J. in Mashonaland's case is still valid under English law, it may not apply to an executive director who is employed by the company under a contract of service. Where executive directors are concerned the court may, in appropriate circumstances, be prepared to imply into their contract of employment a term that they should not perform services for a competitor even in their spare time.

In Thomas Marshall (Exporters) Ltd v. Guinle,[27] a managing director had agreed in his service contract neither to engage in any other business without

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26. Bray v. Ford, [1896] AC 44 at 51, where Lord Herschell clearly stated that "It is an inflexible rule of a court of equity that a person in a fiduciary position is not, unless otherwise expressly provided, ... allowed to put himself in a position where his interest and duty conflict."

27. [1978] 3 W.L.R. 16

the company's consent nor to disclose confidential information. He was alleged to have done both, to have diverted the company's business to himself and, later to have unilaterally repudiated the contract by resigning without notice. Megarry V. C. held that on those facts he had breached his duty of fidelity and good faith. In this case there was an express agreement not to compete and there was also a diversion of the company's business. On these facts the case cannot be regarded a clear authority for the proposition that competing constitutes a breach of a directors' fiduciary obligation without an express prohibition either in the articles or by contract.

Where a director has contracted to perform substantial services for a company over and above those stemming simply from his position on the board, the court may be prepared to imply a term that the director should not perform similar services for a competitor. In Hivac Ltd v. Park Royal Scientific Instruments Ltd,[28] the plaintiff employed two workers on highly skilled work. In their spare time they both worked for the defendant company on similar work, which was in direct competition with that of the plaintiff company. The court held that the two employees had deliberately and secretly set themselves to do in their spare time something which would inflict great harm on their employer's business. Ordering an interlocutory injunction to restrain their

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28. [1946] Ch. 169

employment by the defendant company, the court emphasised:

> "To say that people in these circumstances can, so to speak, make a division in their minds between what is confidential and what is not, and be quite careful while they are working for the defendant to keep the confidential information locked up in some secret compartment of their minds theoretically may be all very well, but from the practical point of view has certain unreality."[29]

If a worker's duty of fidelity, which imposes fewer obligations than the full range of fiduciary duties owed by directors to their companies, can preclude him from engaging in work for a competitor, how then, can a director compete with his own company? It is quite possible for a director to disclose important confidential information, which has been acquired in his position as a fiduciary of one company, to a competing company. By passing confidential information to a competitor there is the likelihood of serious harm being caused to the company.

Where a director serves on the board of different companies, there is also the potential problem of the interests of shareholders being subordinated to the opportunity for personal gain which is afforded the director by his fiduciary position. Apart from the subordination of shareholders' interests, the incentive for the director to serve each company in accordance with his

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29. at p.173

fiduciary duty is lessened in any dealing which involves competing companies. Recognising this potential problem Farrar and Hannigan argue that it would seem impossible for a director to act for very long for two competing companies before he would find himself in an intolerable position. According to them a director cannot serve two masters at once and would inevitably be in breach of his duties to one or the other.[30]

Under U.K. law there is an anomaly between the duty imposed on directors, as fiduciaries, not to place themselves in a position where their interests and duty to the company may conflict, and the latitude which the law extends towards the practice of a director holding office in two companies which might even be competing. Apart from the issue of conflicting interests, there is also the potential for disclosing confidential information acquired in the position of director.

C) INTERLOCKING DIRECTORATES IN THE UNITED STATES

Brandeis had attempted, through a number of writings, to focus public attention in the U.S. on competitive abuses and the conflict of interest

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30. Farrar, J.H. , and Hannigan B.M., Farrar's Company Law (4th ed.), 1998, 414, Butterworths.

problems which he saw as the fruits of widespread interlocking directorates.[31] This brought about public awareness and concern over the problems resulting from these arrangements. The complex networks of inter-corporate relationships convinced many observers that there was a core group of managers who controlled a great number of U.S. companies. Investigations revealed evidence that interlocking corporate management was a widespread practice which had been used as a vehicle of personal gain and serious conflicts of interest amongst directors.[32]

An investigation by the Pacific Railway Commission into the management of railway companies, disclosed significant abuses in railway construction, leases and repair contracts allegedly attributable to four Central Pacific Railroad Company directors who also controlled the companies which were parties to the contracts with Central Pacific.[33] During an investigation of United States Steel Corp.,[34] the committee unveiled instances involving

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31. Brandeis, Breaking The Money Trusts, Harpers Weekly, Nov. 22, 1913 at 10;

32. Pam M, Interlocking Directorates, The Problems And The Solution (1913), 26 Harv. L. Rev. 467, states that these investigations uncovered common directors on the board of competing companies which resulted in board meetings being turned into ceremonial occasions with minimum input of time and effort.

33. The Pacific Railway Commission, Executive Document , No. 51, 50th Congress, 1st Sess. (1887) - normally referred to as The Pettison Report

34. See H.R. Rep. No. 1127, 62d Cong., 1st Sess. (1912) - normally referred to as The Stanley Report.

anti-competitive practices in companies effected through the vehicle of interlocking directorates. The Committee noted :

> "The complicated web of agreements in restraint of competition, ... the inordinate sums paid to promoters and underwriters are concrete instances of abuses directly traceable to this community of interest between a few powerful individuals in control of a number of great corporations."[35]

President Wilson also spoke strongly against corporate interlocks and emphasized that the result of interlocking directorates might be a collusive relationship between the non-executives and the executive team which they are supposed to monitor on behalf of shareholders. He argued that corporate boards had to move on from the cosy clubs to diverse independent bodies in order to be able to fulfil this important role. He made it clear that there was a need for legislation which would render interlocking relationships between corporate directors illegal. In a message to Congress he asked for a law which would :

> "prohibit and prevent such interlockings of the personnel of the directorates of great corporations ..... which in effect result in making those who borrow and those who lend practically one and the same, those who sell and those who buy but the same person trading with one another under different names and in different combinations."[36]

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35. Stanley Report, supra note - 34 at 209-10

36. H.R. REP. No. 627, 63d Cong., 2d Sess. 18 (1914) at 18

1. Statutory Prohibition Of Interlocking Directorships

a. The Clayton Act

The publication of congressional reports that resulted from these investigations together with the articles of Justice Brandeis and the public speeches of President Wilson generated intense public reaction and this led, to the enactment of Section 8 of the Clayton Act.[37] This section reads:

> "No person at the same time shall be a director in any two or more corporations, any one of which has capital, surplus and undivided profits aggregating more than $1,000,000, engaged in whole or in part in commerce, other than banks, banking associations, trust companies, and common carriers subject to the Act to regulate commerce ....if such corporations are or shall have been heretofore, by virtue of their business and location of operation, competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the provisions of any of the antitrust laws. The eligibility of a director under the foregoing provision shall be determined by the aggregate amount of the capital, surplus, and undivided profits, exclusive of dividends declared but not paid to stockholders, at the end of the fiscal year of said corporation next preceding the election of directors, and when a director has been elected in accordance with the provisions of this Act it shall be lawful for him to continue as such for one year thereafter."

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37. Section 8 of the Clayton Act, 15 U.S.C. S.19 (1970)

Despite President Wilson's call for legislation that would prohibit both vertical and horizontal management interlocks[38] the United States Congress responded in a narrow manner by prohibiting only horizontal interlocks.[39]

Section 8 of the Clayton Act contains three important conditions that have to be fulfilled before interlocks amongst directors can be prohibited. Firstly, one of the companies involved should have capital, surplus and undivided profits in excess of $1,000,000. Secondly, the companies should be engaged in commerce and thirdly, the companies should be competitors. It also has a problematic exemption clause which exempts banks, banking associations, trust companies, and common carriers from the prohibitions of the section.

i. Initial Strict Interpretation Of Section 8 of the Clayton Act By The Courts

The older, more stringent view of the courts was that contracts between companies with common directors were voidable at the option of either company without regard to fairness. With the use of this strict view by the courts, the scope of the bank exemption was put to test in a number of cases

38. A vertical interlock is one between companies situated in a supplier-customer relationship - Brown Shoe Co v. United States, 370 U.S. 294, 323 (1962), while a horizontal interlock is one between companies performing similar functions in the production industry or sale of goods or services - Ibid at 334

39. This is evident in the wordings of Section 8

In United States v. Crocker National Corp.[40] a director of Bank of America National Trust and Savings Association, sat on the board of Prudential Insurance Company. A member of Prudential's board also sat on the board of Bank of America National Trust and Savings Association. Three other individuals on the board were also directors of Crocker National Bank, Equitable Life Assurance Society of the United States, and Metropolitan Life Insurance Company. The main issue was whether the clause "other than banks" prohibits interlocks between banks and non-bank competitors.

The Court of Appeals for the Ninth Circuit, held that the Clayton Act prohibits interlocks among banks and insurance companies. The court noted that the Act was meant to apply to all sectors of the economy in addressing the problems caused by interlocking directorates.

In United States v. Sears, Roebuck and Company,[41] the Government brought a Section 8 action because a Sears' director also sat on the board of B.F. Goodrich Co. Sears contended that the enforcement of Section 8 required

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40. 656 F. 2d 428 (9th Cir. 1981); See also Alabama Fidelity Mortgage & Bond Co. v. Dubberly, 73, SO 911 (Ala 1916).

41. III F. Supp. 614 (S.E.N.Y. 1953)

a finding that the interlocked companies were violating a particular law or acting illegally. Rejecting this argument the court held that the mere existence of interlocking companies constituted a violation of Section 8 of the Clayton Act.[42]

ii. The Present Approach Of The Courts To Section 8 Of The Clayton Act

The U.S. courts have now come to realise that to forbid common directors from participating in inter-corporate dealings is impracticable and unworkable. They have now adopted a flexible rule under which the courts scrutinise the influences of existing interlocks and determine the fairness and reasonableness of a contract if it is challenged. The courts are now in the position of taking a case-by-case approach, when scrutinising the motive and fairness of each challenged contract.

In Continental Copper and Steel Indus. v. Johnson,[43] a company's directors' and officers' liability insurance policy was held to cover expenses in defending suits against its directors, even though the suits arose out of their duties as directors of another company, where they were serving on other

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42. Supra at 621

43. 491 F. Supp. 360 (S.D.N.Y. 1980)

companies' boards at the insured company's request. In re Illinois Valley Acceptance Corp. v. Martin,[44] it was held that transactions between companies with interlocking directorates are merely voidable and that the possibility of rendering them void would depend on proof of fraud or unfairness. The standards that are applied to cases of interlocking directorate are the same as those applied to interested director cases where there is the potential for conflict of interest.

In Globe Woolen Company v. Utica Gas and Electric Company[45] the plaintiff company sued to compel specific performance of contracts to supply electric current to its mills. The defendant company felt that the contracts were made under the dominating influence of a common director and were unfair and oppressive. Maynard, the plaintiff's major shareholder and a member of its board of directors, was also a director of the defendant and chairman of its executive committee, holding a single share to qualify him for office. Maynard presided at the defendant's executive committee at which the contract was ratified, but did not vote. Holding that the contract was voidable at the defendant's option, the court stated that:

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44. 531 F. Supp. 737 (C.D. I'll. (1982)

45. 121 N.E. 378 (1986)

> "there was still a duty on the part of Maynard to warn the company of the oppression which was either apparent on the surface or lurking beneath the surface[46]

This prevailing position indicates that the U. S. courts will not give an arbitrary right to either company to enforce a contract entered into by common directors but will use the fairness standard to scrutinise each case.

b. The Federal Trade Commission Act

Section 5 of the Federal Trade Commission Act[47] regulates interlocking arrangements irrespective of their legal status under Section 8 of the Clayton Act. The pertinent language of Section 5 states :

> " Unfair methods of competition in commerce, or deceptive acts or practices in commerce, are declared unlawful.
>
> The Commission is empowered and directed to prevent persons, partnerships, or corporations, except banks, common carriers subject to the Acts to regulate commerce, air carriers and foreign air carriers subject to the Federal Aviation Act of 1958, and persons, partnerships or corporations insofar as they are subject to the Packers and Stockyards Act, 1921, as amended, except as provided in Section 406(b) of said Act, from using unfair methods of competition in commerce and unfair or deceptive acts or practices in commerce."

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46. Ibid at 380; see also Ramacciotti v. Joe Simpkins, Inc., 427 S.W. 2d 425 (1978)

47. 15 U.S.C. Ss. 45(a) (1970)

Under this provision of law the Federal Trade Commission (F.T.C.) has the power to deal with specific instances in which interlocking arrangements are found to either be anti-competitive or serve as vehicles for the promotion of anti-competitive activities. In F.T.C. v. Brown Shoe Co.,[48] the Supreme Court found, in the legislative history of Section 5, congressional intent to confer on the F.T.C. the power "to arrest trade restraints in their incipiency without proof that they were outright violations of competition laws."[49] It is, however, noteworthy that Section 5 of the Federal Trade Commission Act specifically exempts banks from its coverage. The implication is that where bank interlocking arrangements and practices are challenged, there are limits on the F.T.C.'s power to issue an order against the bank.

D) INTERLOCKING DIRECTORATES UNDER GERMAN CORPORATE PRACTICE

Under German law the appointment and removal of corporate managers are not directly exercised by shareholders but by the supervisory board. This makes seats on the supervisory board important for shareholders who desire a say in corporate control. In recent times, the emphasis of the supervisory

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48. 384 U.S. 316 (1966)

49. Also F.T.C. v. Sperry and Hutchinson Co., 405 U.S. 233 (1972); Atlantic Refining Co. v. F.T.C., 381 U.S. 357 (1964)

board's work has shifted towards advising and counselling the management board and this has serious implications for the running of companies.[50] Monitoring is no longer felt to be just a question of detecting past mistakes but includes preventing them from being made in the first place, with the effect that the monitors should have expert knowledge and a comprehensive understanding of business policies.[51] Under German Co-determination law, although members of the management board may not sit on the supervisory board, one individual may hold up to ten supervisory board positions[52], thus many interlocks may exist at the supervisory board level.

1. The Development of Board Interlocks

In contrast to the positions in the United Kingdom and the United States, German universal banks combine a range of banking functions, with deposit-taking, lending on credit, capital-raising, investment banking, foreign exchange operations, and industrial shareholdings all being undertaken by one bank. The emergence of banks with multiple roles is closely related to

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50. Steinherr A. and Huveneers C, Universal Banks : The Prototype of Successful Banks In An Integrated European Market, A View Inspired By German Experience, 1990, Centre For European Policy Studies Research Report 2, p.63

51. Schneider-Lenné, Corporate Control In Germany, 8(3) Oxford Review Of Economic Policy 11 at 20

52.Section 102(1)(b) AktG 1965

the economic development of German capitalism of the late nineteenth century. There was, then, an urgent need for long-term capital to back up the move to industrialisation. The private banking system was inadequate for this purpose and there was also a lack of private investors who were ready and able to finance the construction of a modern economy.[53]

The universal banks[54] which resulted had a common interest - to finance and control German industrialisation. Each of these banks tried to become the 'house bank' to one or more of the new industrial giants with the aim of keeping those companies as long-term customers. The banks sought to build up exclusive relationships by acquiring shares in the companies and sitting on their supervisory boards.[55]

With such inter-relationships between the universal banks and various companies through representation on supervisory boards, a network had developed where directors appointed by the banks sat on the supervisory boards of various companies simultaneously. Although German law limits one director to ten directorships, banks are still able to exercise

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53. Tilly, R.H. German Banking 1850-1914: Developmental Assistance For The Strong, (1986)15 J. Eur. Econ. Hist (1986), 113

54. Deutsche Bank and Commerzbank were both founded in 1870 and Dresdner Bank was founded in 1872

55. Katzenstein P. J. (ed), Industry And Politics In West Germany, 1989,Cornell University Press : Ithaco, 1989, 275

considerable influence through board representations. Companies that are in financial difficulties tend to form close associations with other companies and financial houses. These other companies can be in the same industry since there is no rule, under German law prohibiting directors from serving on boards of competing companies. Through these interlocking directorates, the banks are said to be in a position to obtain unpublished information which enables them to monitor the management of these companies.[56]

2. Interlocking Directorates As One Of The Main Sources Of Bank Power

Banks, on their part, also find it advantageous to become associated with large companies by appointing officers to their boards. This may attract large deposits as well as secure reliable customers for bank loans. By such interlocks, the banks are able to gain an insight into underlying information from business connections which are not accessible to the general public.

Under German corporate practice, a bank will, therefore, demand a seat on a company's board if it holds a significant fraction of its shares and such directorships allow the bank to monitor and sometimes manipulate corporate actions. To this effect Fitch and Oppenheimer have stated that:

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56. Cable J, Capital Market Information And Industrial Performance : The Role Of West German Banks, 1985, 95 The Economic Journal 118 at 122

> "For bankers ..... the potential advantages of interlocks are multiple. They are a means of ensuring - or trying to ensure - that the corporation does not jeopardise the bank's investments. The interlock may also ensure that the bank is allowed to service the corporation's financial needs."[57]

The powers of German banks can, therefore, be said to derive from three main sources : board interlocks, corporate debt obligations and voteable shareholding and these constitute direct tools for monitoring and decision-making. It has, however, been argued in favour of interlocking directorates by German universal banks that it is their expertise and experience which make bank representatives particularly suited to perform this important function.[58]

Commenting on the advantages that may be derived by bank participation on the supervisory boards of other companies Schneider-Lenné notes :

> "The figures reveal that the influence exerted by banks via their supervisory board mandates is quite substantial ..... If banks wield greater authority it is because of their expertise in financial matters, which via supervisory board mandates feeds through into the management of the company."[59]

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57 Fitch R. and Mary Oppenheimer, Who Rules The Corporations ?, July/August 1970, Part I Sociologist Revolution, 100

58. Deutsche Bank, Long-Term Trends In The Banks' Investment In Securities, 1987, Deutscher Bundesbank Monthly Report, 39 at 41; Baum T, Should Banks Own Industrial Firms? Remarks From the German Perspective, 1992, Revue de la Banque de Belgique 5 at 11

59. Schneider-Lenné E, Corporate Control In Germany, 8(3) Oxford Review Of Economic Policy, 11, 19

With bank representatives being appointed to the shareholder seats on the supervisory boards, German companies enjoy the specialised knowledge of bank personnel. Bank participation at board level, therefore, enhances business relations and brings long-term benefit to both sides.

Another argument in their favour is that banks exercise influence more in the sense that information is exchanged and common strategies are discussed between representatives of the banks and those of the executive board in the forum of the supervisory board. This, in essence, is a form of mutual dependency. Such close relationships between banks and other companies enable the banks to be involved in the long-term planning and decision-making processes of companies. The inclusion of bank representatives on a company's supervisory board may result in an enhancement of the credit-worthiness of that company. With large banks acting in advisory roles in the formulation of corporate financial policies, the result may be the implementation of policies which are in the long term interest of companies.[60]

Critics of interlocking directorates by German banks have, however, argued that the influence of bank representatives on company boards tend to bind such companies to a given bank which is likely to lead to the lack of

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60. Esser J, Bank Power In West Germany Revised, 1990, 13 West European Politics, p.17 at 29

competition and improvements. Commenting on the powers exerciseable by banks through their representatives on the boards of other companies, the Monopolies Commission, as far back as 1975, had stated :

> "The position of the banks in the economic system has partially institutionalised itself independent of their role as lenders of credit : the banks are represented on the supervisory boards of numerous large firms; as important shareholders in these firms, the banks should take their voting rights seriously; their stakes in companies are multidimensional, in legal and other ways ..... it can, therefore, be argued that, through a combination of these functions, the banks can substantially influence a good portion of the overall decision-making of the large firms."[61]

In its sixth main Report in 1986, the Monopolies Commission continued to argue that the accumulation of power by banks through direct shareholdings, supervisory board positions and proxy voting right was threatening. This was depicted by the representation of the largest banks on the supervisory boards of the biggest German companies that year - the Deutsche Bank had representatives in thirty-nine of them, the Dresdner Bank in twenty-two, the Commerzbank in fifteen and the Allianz-Versicherung (insurance group) in seventeen[62]. Apart from the anti-competitive tendencies, bank interlocks are also criticised as putting banks in

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61. German Monopolies Commission 1973-1983, Summaries Of The First Five Bienniel Reports, Bader-Bader : Nomos,1987 p.19.

62. Esser J, supra note 55 at 25

the advantageous position of gaining insight into confidential, underlying information regarding business transactions.

E) CONCLUSION

By appointing directors to the board, shareholders entrust them with the protection of their interests through overseeing management decisions and policy actions. With the practice of interlocking directorates having the potential of leading to unfair favouritism, anti-competitive tendencies and conflicts of interest, the question is whether directors actually protect shareholders' interests when they sit on the boards of various and even competing companies at the same time? It is obvious that interlocks on corporate boards create collusion between the non-executive directors and the executive team which they are supposed to monitor on behalf of shareholders.

In the U.S., two different approaches have been adopted by the court in cases involving interlocking directorates. Under the older, more stringent approach, contracts between companies with common directors were voidable at the option of either company without regard to fraud or fairness. The new and prevailing position is that contracts between companies having directors in common are voidable only for fraud or unfairness. This is based on the reasoning that directors should be permitted to represent different companies subject to judicial supervision as to fairness and good faith. Provisions imposing a good faith standard are sometimes included in articles of incorporation or even bylaws. Where that is the case, the fairness and good faith of contracts between companies with interlocking directors will be carefully scrutinised.

Under German law the common practice of interlocking directorates may give rise to conflicts of interests with bank representatives sitting on the boards of various companies. Good business practice should require that information obtained from participation on one board should not be passed on to the board of another company. In particular, banks should not use such information for the benefit of other clientele, namely investors they serves in other capacities. At the same time investors should be provided with all information relevant to their investment decisions. Given this situation it is obvious that there is the potential for a conflict of interests to arise. Insight into confidential information has the potential for abusing such information to the detriment of the company involved, other investors and the public.

Given that the law in the three systems under study imposes in each case a no-conflict rule on directors, it might have been expected that competing interlocking directorships in the same industry would be generally precluded. The U.S. has been foremost in attempts to regulate interlocks on corporate boards. By the provisions of Section 8 of the Clayton Act and Section 5 of the

Federal Trade Commission Act interlocking directorates have been prohibited in some industries. Apart from the statutory regulation of interlocking directorates the U. S. courts go to the trouble of scrutinising each case of interlocking directorship, brought before the court, to determine its influence on corporate transactions and to ensure fairness and reasonableness.

Courts in the U. K. have simply recognised that a director of two rival companies is walking a tight-rope and at risk if he fails to deal fairly with both companies.[63] It is difficult to reconcile the duty imposed on fiduciaries as declared by the English courts in the partnership case of Aas v. Benham and the trustee case of Re Thomson with the holding of Chitty J. in London and Mashonaland Exploration Co v. New Mashonaland Exploration Co and the dictum of Lord Blanesburgh in Bell v. Lever Brothers Ltd.

One would have thought that the same principles would apply with as much if not more rigour and force to company directors as they do to other fiduciaries. If anything this principle ought to apply with greater force to company directors since they enjoy remuneration while some other fiduciaries such as trustees provide their services free of charge.

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63. Scottish Co-Operative Wholesale Society v. Meyer [1958] 3 All E. R. 56

CHAPTER TEN

CONCLUSION AND RECOMMENDATIONS

The main aim of this research was to examine the right of control exercisable by the general meeting through their powers to appoint and remove directors. It also aimed at determining whether corporate control through this channel fulfils the intended purpose – that of enabling shareholders to determine the composition of corporate boards. The work proceeded to consider the principles, regulations and laws which underlie this aspect of internal control in the United Kingdom, United States and Germany.

This final chapter is divided into three parts and starts by reflecting on the main observations made in earlier chapters. After reviewing the different aspects of the research it comes to the conclusion that although the corporate control mechanism in all three systems have short-comings, each system has its own strong areas. This leads to the second part which answers the question whether each system should simply import the best features of other systems? The final part proceeds to make recommendations by putting forward proposals which should help address the problems that have been identified.

A) AN OVERVIEW

CONTROL IN COMPANIES

There are important differences in the control of companies in the UK, US and Germany as highlighted in chapter 2 of this work. The Anglo-American system illustrates the problems caused in many companies by the separation of ownership from control. In many cases, with their small stake in companies, individual shareholders have little incentive to attend and vote at general meetings. They tend to hand their votes over to others who are sometimes selected by management which leaves control in the hands of the directors.

In an attempt to address this problem the Anglo-American system has relied on non-executive directors to protect shareholders' interests[1]. Where non-executive directors are not completely independent of the executive team they may not be in a position to challenge management decisions and take appropriate actions on shareholders' behalf.

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1. Chapter two of this work deals with this issue.

The UK corporate control arena has experienced broad consultation processes which have resulted in recommendations of self-regulatory standards based on codes of best practice[2]. In the US, corporate control is based more on legal rules than self-regulatory codes with members being given rights that their U. K. and German counterparts do not enjoy[3].

Under the German system concentrated blocks of shares are supposed to give German shareholders a strong incentive to monitor management. The two-tier board system together with the practice of co-determination may actually go a long way to affect shareholders' control rights over the affairs of their companies.

This chapter concludes that shareholders are not well protected by the powers to appoint and remove directors since management in the Anglo-American system selects its own candidates for the board – typically similarly situated chief executives of other companies. This leaves managers free to pursue

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2. The Report of the Committee on the Financial Aspects of Corporate Governance (The Cadbury Report), 1992, London: Gee & Co; The Report of The Study Group on Directors' Remuneration (The Greenbury Report), 1995, London: Gee & Co; The Report of the Committee on Corporate Governance, (The Hampel Report), 1998, London: Gee & Co,.

3. Foremost of these are the efforts of the Securities Exchange Commission in regulating different areas of internal control in companies - The Securities Exchange Act Release No 34-31326 (16 October 1992) through which the Securities Exchange Commission (SEC) has made communication among shareholders less burdensome; Also the Securities Exchange Act Release 34-31327 (Executive Compensation Disclosure) (1992) - which describes in details how executive compensation decisions are to be communicated to shareholders.

their own agendas unchecked by the board. German shareholders are, however, not better-off than their Anglo-American counterparts. Apart from the issue of co-determination voting control is exercised by banks who benefit from their monitoring function since they fulfil multiple roles[4].

INSTITUTIONAL HOLDERS

Institutional shareholders have the expertise and resources to monitor corporate management and may have an incentive to intervene as their holdings are usually too large to sell off without affecting the market. U.K. institutions have started to have active dialogue with corporate managers in an attempt to intervene where companies are not properly managed[5]. Despite attempts by institutions in this system at collaboration there is still a need for greater activism by this category of shareholders.

Although there is evidence of activism by major U.S. institutions such as the California Public Employment Retirement Systems (CalPERS), there are limitations on institutional intervention in that system. One of the mitigating factors against institutional activism is the enactment of laws which limit the

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4. See Chapter two of this work at pp 56-59; To this effect Schmalenbach has indicated that individual shareholders' involvement in German companies is less prominent than in the U.K. and U.S. - Schmalenbach, D., Federal Republic of Germany, in Lufkin and Gallagher (eds), International Corporate Governance, (1990), 110, London: Euromoney

5. This position has been highlighted in chapter three pp. 77-79

ability of large financial institutions to hold concentrated blocks of shares. As a result, the level of concentration or cohesion by institutions found in the U.K. has not been experienced in the U.S. Despite the lack of legal restrictions in the U.K, however, institutional activism is sometimes constrained by the cost of forming shareholders' coalitions.

Although German companies enjoy the support of large, powerful, long-term shareholders, there is no significant participation by small or individual investors in their control systems. Institutional investors in that system have the ability to influence corporate management by patient, informed interaction. German creditors also have stronger rights than their counterparts in the UK and the US, with a resulting weaker shareholder right due to their co-determination system.

With ownership of German companies being concentrated in the hands of a small number of large companies, especially banks, the dispersed ownership of shares among a large number of individuals and institutional investors in the UK and the US makes a good contrast. This is significant as it depicts a stronger relationship between German institutional investors and their companies.

Although more direct monitoring and information gathering by institutions may be associated with German corporate practice than is the case with institutions in the UK and US, yet in their multiple roles German institutions are generally slow to act and only take actions in crisis situations. It would therefore be incorrect to conclude that shareholders' interests are better represented in that system as the German structure simply encourages the representation of other stakeholders' interests and does not give the necessary control to shareholders.

In all three countries there have been debates about the role of institutional shareholders, both in respect of previous management errors and taking preventive actions. Despite their growing predominance, institutions have not exercised the level of control which identifies them as owners rather than mere investors.

THE STATUTORY AND REGULATORY FRAMEWORK

The statutory and regulatory frameworks on the appointment and removal of directors do not actually give shareholders the power to determine the composition of company boards as they portray. A number of important points can be gathered from chapter 4 in this regard.

In the U.K. there is evidence that when filling casual vacancies management picks the directors they believe will not "rock the boat." Although Section 303 of the Companies Act 1985 entitles the general meeting to remove a director by passing an ordinary resolution, a restraint on the exercise of this power is directors' right to claim compensation or damages in respect of a termination. With the board (including the executives) having the power to appoint the executives and to fix their terms of service[6], it is not surprising that directors entrench themselves through long service contracts.

In appropriate circumstances the removal of a director may result in the winding up of a company on the just and equitable ground or may warrant the less stringent remedies of an unfair prejudice petition. In addition a company may include a provision entitling directors to weighted voting rights on any resolution to remove a director. All these are valid methods used by directors to prevent their removal thus entrenching themselves on the board.

In the U.S. the applicable common law rule is that shareholders have no power to remove directors before the expiration of their term, except for cause. This common law prohibition against removal can only be modified by statute. Where a state statute does not give shareholders the right to remove without cause, a director will be able to continue in office despite the opposition of a majority of the shareholders.

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6. See chapter four of this work at pp.126-128

Co-Determination Laws allow German employees to appoint up to half of the supervisory board members to represent them. Those employee representatives can only be removed by a resolution of the employees. A notable difference between U.K. law and those of U.S. and Germany is that in the last two systems minority shareholders have the right to petition the court to remove directors for substantial cause. This is useful where shareholders wishing to remove directors cannot obtain the required majority vote.

BOARD STRUCTURE

Chapter 5 has highlighted board structures in these three systems and how they affect shareholders' powers to appoint and remove directors. By appointing independent/outside non-executive directors shareholders in the Anglo-American system are supposed to rely on this impartial group to closely monitor management actions and policy decisions[7].

Despite the recommendations of the different committees[8] that company boards should have non-executive directors who are completely independent of the executive team, the practice is still for the executives to pick the slate of the non-executives. This problem is exacerbated where the chief executive

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7. See Chapter 5 of this work at p. 160

8. An example is the recommendation of the Cadbury Committee in chapter five at p. 165

director is also the chairman of the board. Another problem faced by the unitary board is that the function of management is entangled with that of supervision with the effect that non-executive directors are jointly liable for the actions of the executive team.

With the two-tier board system, German corporate practice appears to provide a clear separation between the executive (the management board) and non-executive directors (the supervisory board), with the primary function of the supervisory board being to appoint, oversee and remove members of the management board. As representatives of other companies rather than individuals sit on the supervisory boards there is a greater chance of continuity which may result in long-term policy planning. In addition such representatives of large companies have their companies' reputations at stake when sitting on the supervisory board of another company.

The rights given to employees under the Co-Determination Laws, however, constitute a limitation on German shareholders' right to determine the composition of the supervisory board[9]. When compared with the UK and US positions, where employee involvement in corporate decision-making is discretionary, German shareholders are definitely at a disadvantage.

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9. See Chapter 5 at p. 204; Also Prowse, S., Corporate Governance In An International Perspective: A Survey Of Corporate Control Mechanisms Among Large Firms in the U.S., U.K., Japan and Germany, 1995, New York University Press, 30

From these it becomes clear that neither the German two-tier boards nor the unitary boards of the Anglo-American system enable shareholders' interests to be properly represented on the board.

PROXY VOTING

Chapter six, which dealt with proxy voting, showed that as it is difficult for some shareholders to be present at general meetings, proxy voting allows absent shareholders to cast their votes. A proxy creates an agency relationship which can be revoked at any time with the proxy being bound to obey the voting instructions of the principal. This becomes awkward when the proxy-holder is in the management team and in a position of greater knowledge and power than the principal. The relationship is also abnormal as the agent is normally the one that solicits the principal to establish the relationship.

While management solicits proxies from shareholders at the company's expense persons wishing to oppose management have to solicit proxies at their own expense which turns out to be an expensive venture. The proxy system which should give shareholders a say in the companies that they invest in has, therefore, not been an effective mechanism for shareholder representation. Management has access to the shareholder list for the purpose of solicitation with the result that the electoral system can be manipulated to reduce the effect of shareholders' voting rights.

In the U.S. rules have been developed to regulate proxy voting which have gone a long way to reduce the abuse of this machinery. These are embodied in Rule 14a of the Securities Exchange Act of 1934 (as amended in 1992). The 1934 rules have enhanced shareholder voting by making the process of proxy voting more fairly implemented. The amendments of 1992 have made the process even less burdensome for shareholders by enabling them to communicate among themselves. This has made it possible for shareholders to take actions as a group, thus maximising their influence at general meetings.

Under German corporate practice individual shareholders normally deposit their shares with banks who vote them as proxies. They can use these votes to appoint their nominees to the supervisory boards, therefore, dominating the shareholders' side of that board. Through the depository share voting rights German banks occupy a real position of power and may not be in a position to represent the interest of shareholders because of their multiple roles as lenders, commercial bankers, brokers and equity holders. This may result in conflict of interest as banks may exercise other shareholders' votes in a way that safeguards their personal interests.

In the U.K. and Germany the proxy voting machinery has fallen short of its main purpose – that of providing shareholders with a means of voting even when they are absent from general meetings. With the proxy rules that have been put in place in the U.S, U. K. and Germany have a long way to go in this direction.

DISPROPORTIONATE VOTING ARRANGEMENTS

Disproportionate voting arrangements confer on some groups voting rights which exceed their equity stake in the company. Chapter 7 explored the trends in disproportionate voting arrangements and how they affect the voting rights of shareholders. As shareholders' votes constitute an essential element of corporate control, arrangements such as shares with multiple voting rights and non-voting shares allow a small group to obtain and maintain control. In the U.K., companies have used such arrangements as fractional shares and exchange offers in addition to multiple and non-voting shares, to ensure that management insulates itself from possible shareholders' action and removal.

There has, however, been a recent move by companies to change their dual share structure in respect of multiple voting shares. Despite this there still exists fractional shares, non-voting shares and exchange offers with the effect that the minority may end up with majority votes on all or specific occasions. Although the London Stock Exchange regards disproportionate voting arrangements unfavourably, no positive step has been taken to prohibit them.

In the U.S. the initial rule was one-share-one-vote which was applicable in most states through States' Corporate Charters. This position was changed and companies began to issue two classes of ordinary shares: one having full voting rights and the other having no right to vote. The resulting opposition to this practice moved the U.S. courts and Securities Administrative Bodies to take a strict stand on companies' voting structure. The New York Stock Exchange (NYSE) was foremost in disapproving the issue of shares with disproportionate rights.

Under German corporate law the ability of a company to issue shares with disproportionate voting rights is regulated by the Limited Liability Company Act (GmbHG) 1980 and the Public Company Act (AG) 1965. Although multiple voting isprohibited under German law an alternative device of voting by graduation (also known as voting on a sliding scale) is used. By this method a shareholder who possesses more than a certain number of shares may cast proportionately fewer votes in respect of the excess. By using this method, voting rights are deprived the shares that are in excess of the limit thus a modification of the rule 'one-vote-one-share'.

It is clear from all these arrangements that by stripping shareholders of their voting rights, the power of shareholders to determine the composition of company boards and control their companies could be significantly limited. Disproportionate voting tends to shield management from exposure to the full glare of shareholders and can work to free directors from the slightest element of accountability.

VOTING AGREEMENTS AND VOTING TRUSTS

Under the traditional corporate structure shareholders have a role which they play through the exercise of their voting rights. Shareholders' voting power is inherently annexed to and should be inseparable from ownership of shares. Chapter 8 focused on voting agreements under which shareholders form coalitions to vote in a particular way and trust agreements under which voting rights are transferred to a trustee for a definite period. These arrangements are used in the U.K. and U.S. but they are not permitted under German law.

Under U.K. law the courts have upheld shareholders' voting agreements as valid ways by which shareholders can exercise their property rights. In this system a shareholders' agreement is sometimes regarded as an informal agreement equivalent to a resolution of the general meeting. The rationale for this being that such an arrangement represents a meeting of minds of all involved which is the essence of a general meeting. Voting trusts, although not in common use in the U.K., can be used to ensure that a particular group wields control in a company.

In the U.S. the courts initially took a very strict view on voting arrangements entered into by shareholders. Such arrangements were almost invariably held to be invalid when challenged. The view of the U.S. courts then was that the voting powers of shareholders should not be separated from ownership. With the statutes of most states validating shareholders' voting arrangements, there has been a change in judicial thinking. U.S. courts are now more willing to validate arrangements which, in the absence of fraud on the minority or other illegal object, do not impinge on statutory rights of shareholders.

This work recognises that shareholders' voting arrangements may have the effect of assuring shareholders of a part in the fashioning and execution of corporate policies and changes. Despite their possible good uses, voting arrangements may, on the other hand, be used to deprive shareholders of any level of control in companies. It concludes that shareholders should be in a position to give each other their independent, individual judgement at general meetings after a thorough consideration of the issues presented for approval. They should not simply comply with judgements made long before the problem existed but should be able to vote their shares in what they individually conceive to be in the company's best interests.

INTERLOCKING DIRECTORATES

Non-executive directors have one overriding role: to monitor the activities of the executive team to ensure that shareholders interests are protected. In chapter 9 of this research it was argued that the appointment of the executive directors of other companies to act as non-executive directors, many of whom have a pre-existing business relationship with the company, is fairly widespread in the three systems under study.

U. K. courts have not disapproved of interlocking directorships although they have condemned similar situations where partners and trustees are involved. With the legal recognition of the fiduciary position of directors under U.K. law, it is surprising that the courts have validated these arrangements in view of the potential conflict of interests. The nearest that they have come to condemning it has been the recognition that a director of two rival companies is walking a tight rope.

Where non-executive directors are executive directors of other companies themselves and business acquaintances of the executives on whose board they sit as non-executives, they can hardly be expected to challenge the management team. The fact that the managers of one company serve to oversee the managers of another, therefore, undermines the ability of non-executive directors to monitor corporate managers on shareholders' behalf.

Under U.S. law the disadvantages of interlocking directorates were given early recognition and made subject to statutory control. Section 8 of the Clayton Act 1970 prohibits multiple directorships in companies, other than banks, trust companies and common carriers once three conditions have been fulfilled.[10] Section 5 of the Federal Trade Commission Act 1970 also prohibits interlocking directorates which are anti-competitive or serve as vehicles for the promotion of anti-competitive activities. These regulations on interlocking directorships in the U. S. have gone a long way in restricting this practice.

Under the German two-tier board system although a member of the supervisory board cannot sit on the management board of the same company there are considerable linkages between supervisory and management boards of different companies.[11] The Universal Banks have developed a practice where their representatives sit on the supervisory boards of various companies simultaneously. Although German law limits one director to ten directorships, this still gives directors room to sit on boards of competing companies. Where such directors are bank representatives, with banks' multiple roles, there is likely to be conflict of interests.

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10. See Chapter nine of this work at p. 331 for these conditions.

11. See Chapter 9 of this work at p. 337

B) COMMENTS

From the above observations it can be concluded that the corporate control mechanisms of all three systems under study have serious shortcomings. Under the Anglo-American system shareholders have little impact on corporate decision-making. Boards in that system wield control but bear no risk or exposure to financial losses. In such a situation it becomes difficult to ensure that the board accounts to shareholders (who are the asset owners) as management policy may run contrary to shareholders' expectations and interests.

When the relationship between the supervisory and management board is closely examined, it can be observed that, by and large, the management board cannot be effectively controlled by the supervisory board. The supervisory boards simply follow the corporate strategies of their management boards only to be surprised by their negative consequences. With an average of four to five meetings per year it is obvious that the controlling and monitoring role of German supervisory boards may be superficial.

In the Anglo-American system, individual shareholders generally have little incentive to be actively involved in the running of their company. With freely tradable shares, corporate control relies heavily on the effect of the shareholders' right to sell their shares. The German co-determination framework, on the other hand, gives recognition to wider corporate expectations and responsibilities. The bank-based/two-tier system relies on self-monitoring within a network in which companies monitor each other.

Some of the important differences between U.K. law and that of the U.S. is that in the U.S. shareholders have an inherent power to remove a director for cause[12] and a minority can apply to the courts to have a director removed. In addition to these proxy voting in the U.S. has been tightly regulated to enhance shareholders' voting rights. In the U. K. very little has been done by way of regulation with the result that management controls this voting machinery to the detriment of shareholders.

These differences in the corporate structure of the three systems under study raise an important question - whether each system should simply import the best features of other systems?

C) POSSIBILITY OF CONVERGENCE OR HARMONISATION

It has become obvious that the workings of the different systems are shaped by local factors, rules and other circumstances making them better suited to the prevalent conditions of the particular system. Any suggestion of importing the best features of one system to the other should give recognition to these differences in the structure of companies, cultural and financial factors of different systems. Proposals to make the three systems exactly the same would be unrealistic to implement and should therefore be resisted.

The Anglo-American system would face practical problems if it attempted to move wholesale to an insider system as operates in Germany and vice versa. In the U.K. and U.S. the supervision of a company's activities by its owners is replaced by the self-supervision of managers, and owners exert no direct influence on company policy. Large institutional holdings enable German companies to overcome the dilemma of collective action. The two-tier board system depends, to a great extent, on a stable ownership structure which discourages hostile outside acquisitions and changes in ownership. This appearance of a more effective governance system in German companies has moved commentators[13] to contend that the two-tier, bank-based system has considerable advantages over the Anglo-American market-based system.

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12. See for example Section 141, Delaware Gen Corp. Law, 1994

13. Porter, M., Capital Disadvantage: America's Failing Capital Investment System, Harv. B. Rev., Vol. 70 (Sept./Oct. 1992) p. 65 at 71 - where he makes a call for U. S. to imitate aspects of the German system; There have been similar proposals that U.K. should learn from the German model of corporate governance see Charkham J, Corporate Governance And The Market for Control of Companies, 1989, Bank of England Panel Paper, No. 25, at 21

The lack of effective monitoring and poorly developed external markets, however, constitute serious drawbacks in the German system thus inducing managerial slackness and internal collusion. These, in addition to employee representation on the supervisory board result in the deprivation of shareholders' rights in general, more so as employee representatives traditionally vote with the incumbent management[14]. As a result of these German supervisory boards have been said to have evolved into closed shops, where members work to perpetuate each other's powers and perks[15].

Another obvious problem is that banks, as creditors, may have a preference for limiting the distribution of dividends among shareholders as high retention of profit reduces the risk of the company defaulting on its outstanding debts. This makes internally generated funds consistent with the notion of an entrenched inside system. Proponents of the German system have often stressed the fact that the financial ties and relationships in German companies reduce agency costs and allow investors to monitor managers more effectively than in the UK and the US[16].

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14. Franks, J. and Mayer, C., Ownership and Control, in H. Siebert (ed), Trends in Business Organisation: Do Participation and Co-operation Increase Competitiveness?, 1995, p. 187, Tubingen

15. Steinherr A. and Huveneurs C, Universal Banks: The Prototype of Successful Banks In An Integrated European Market: A View Inspired By The German Experience, 1990, Centre for European Policy

16. Grundfest, J., Subordination of American Capital, Journal of Financial Economics, vol. 27, 1990, 89 at 98

The establishment of a dual or two-tier board system in the UK, for example, would bring about a shift from the "shareholder centred" system to one where power is concentrated in other hands. The tradition of co-determination renders the German model an unsuitable one for UK companies.

Although the present system of control by the general meeting over the board of directors is an inadequate one any attempt at a wholesale transfer of the good aspects of one system to another will conflict with the fundamental differences that exist between them. Differences between Germany and the Anglo-American systems would constitute barriers in any attempt to align the mechanics of corporate governance in these countries. This was well summed up by Hopt and Teubner when they stated:

> To be sure, a transplantation of one national approach to another country is not easily achieved, since the various approaches to corporate social responsibility are intimately connected to national economic and social structures and to political and cultural traditions."[17]

Although the corporate control mechanics of one system cannot be transferred to another, knowledge of the practices of other systems can be used to fill existing loopholes in ones system. With the U.K. and U.S. systems being characterised by a high level of take-over and frequent changes in ownership, the commitment of German owners is worth emulating.

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17. Hopt, K., and Tuebner, G., (eds) Corporate Governance and Directors' Liabilities: Legal, Economic and Sociological Analysis on Corporate Social Responsibility. (1985), Berlin Water de Gruyter, p. v.

Despite the growing dominance of institutional investors in the U.K. and the U.S, institutions in these systems still have little incentive to act or behave like their German counterparts. Institutional shareholders in the Anglo-American system are generally more interested in the current market price of shares and will support any transaction that will boost the immediate market value of their company's shares.

An important difference between U.K. law and that of the U.S. is that in the latter system shareholders have the power to remove directors for cause. This right is usually provided for by state statute.[18] To justify such a removal a director must be guilty of some abuse of trust. The fact that there is no equivalent provision under U.K. law is surprising in the light of the well-established power of equity to remove trustees for substantial cause such as misappropriation.

It is also worth noting that unlike the U.S. position where the court may remove a director on the application of 10% of the shareholders, under U.K. law the courts have no power to interfere with the management of companies even on the basis of directors' dishonesty or inability to perform their duties. As only 10% shareholding is required for the application to court, U.S. shareholders are in a better position to determine the composition of their boards. As the majority vote required to remove a director in the U.K. may be

18. An example is Section 141, Delaware Gen Corp. Law 1994

difficult to obtain thoughts need to be given to this channel of corporate control.

When proxy voting in the U.K. is compared to that of the U.S, where stringent rules are put in place to prevent the abuse of this machinery, the attempts by the London Stock Exchange leaves a lot to be desired. The regulation of specific matters by the U.S. Securities Exchange Commission has enhanced the disclosure of information and communication among shareholders. If similar rules were promulgated in the U.K. they would go a long way to promote the exercise of shareholders' voting rights and the control of their companies.

In the U.S. the courts subject to serious scrutiny any shareholders voting agreement or trust to which not all shareholders are parties. Such a scrutiny is aimed at determining whether it has the potential to operate as a fraud on non-contracting shareholders. One cannot but give credit to this practice as a close check should show whether the agreement has the tendency to induce the parties to promoting their own interests to the detriment of the company. An agreement should only be valid if it works no fraud on other stakeholders and is to the benefit of the company.

In addition to this, the statutory regulation of shareholders voting arrangements in the U.S. makes a good contrast to the U.K. position. Under the laws of most states shareholders can enter into valid voting arrangements as long as they are in writing and signed by the parties involved.[19] Some states' law go to the extent of requiring that potential shareholders should be notified of the existence of such agreements when they are buying company shares.[20] This type of regulations are desirable in the U.K. as they would work to limit irregularities in shareholders voting arrangements.

The present position of corporate control moves one to make a case for a way forward through more serious oversight of the management of companies. The recommendations that follow are a combination of instances where the use of legal rules and better monitoring of management by the board could bring about improvements in corporate control.

D) RECOMMENDATIONS

In all three systems under study there have been debates and proposals for changes to be effected in the area of corporate control.[21] Most of the

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19. An example is Section 218(c) Delaware Gen. Corp. Law 1994

20. An example is Section 616, New York Bus. Corp. Law (Mckinney 1986).

21. Examples are the Cadbury, Greenbury and Hampel Reports in the United Kingdom and the American Law Institute Principles of Corporate Governance in the United States

proposals have centred on strengthening shareholders' rights and role in monitoring the management of their companies. These proposals have stemmed from the realisation that there is an absence of active shareholders who actually play a significant role in the control of their companies. To solve this problem the emphasis has been on changing the board structure to include more independent non-executive directors to represent shareholders interests on the board.

1. MANDATORY SHAREHOLDER ADVISORY COMMITTEES FOR PUBLIC COMPANIES

With the problems faced by shareholders[22] in controlling their companies the existence of a shareholders' advisory committee would constitute a channel for shareholders' involvement. As shareholders remain the ultimate beneficiaries of the company with the main focus being the long-term profitability and welfare of the company, the existence of a shareholder advisory committee would create a forum for shareholders to make their views known. This work recommends that the use of shareholder advisory committees be made mandatory for all public companies.

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22. Chapter two of this work at pp.37-38 discusses shareholders' inability to control their companies

Emphasising the advantages to be derived from Shareholders' Advisory Committees Dent states:

> "Those who can best decide what directors should do are those who will be most affected by their actions; that is, the shareholders. Only when shareholders control the board will they start to figure out....how to handle executive compensation and all the other problems that have long plagued corporate governance".[23]

a) Examples Of Its Successful Use

This type of committee has been extensively used in Italy where the corporate structure consists of the general meeting of shareholders, the board of directors and the advisory committee (Collegio sindacale). The rationale for the existence of this committee is to provide a machinery by which the actions of directors can be kept under control and the operations of the company reviewed in the interest of shareholders.[24] The functions that Italian law assigns to the collegio sindacale are:

1. oversight of the general operation of the company;
2. review of management actions to ensure that they align with

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23. Dent, G. W., Towards Unifying Ownership And Control In The Public Corporation, 1989, Wisconsin L. Rev. 881 at 914.

24. See Visentini, G., Compatibility And Competition Between European And American Corporate Governance: Which Model Of Capitalism?, 1998, Brooklyn Journal of International Law I.

shareholders' interests; and

3. checking of company's accounts and auditors' reports to ensure that they reflect the true financial position of the company.

This committee has the power to make comments and observations to directors and shareholders in their respective meetings. It also has an autonomous power to call a general meeting of shareholders to discuss and take actions on serious irregularities in the operations of the company that require immediate action.[25]

Another example of successful use of a shareholder advisory committee has been the American oil company, Exxon. This committee was designed by Exxon as a machinery for shareholder involvement in order to minimise free riding among shareholders.[26] Under the Exxon arrangement any shareholder or group of shareholders may submit a proposal to the company to be elected as shareholder representative. Members of the committee are compensated for costs incurred and for time expended on the company's business. The main task of this committee is to review all areas of the company's business and advise the board of directors and the general meeting of its views.

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25. See Pinto A.R and Visentini G., (eds), The Legal Basis of Corporate Governance In Publicly Held Companies: A Comparative Approach, 1998, 105-107, Kluwer Law International.

26. See Monks R.A.G. and Minow N., Watching The Watcher, 1996, 275, Blackwell Business.

b) The Proposal

These examples give one an insight into the operation of shareholders' advisory committees. Where the establishment of such a committee is made a requirement for all public companies it may go a long way in solving the problem of shareholder passivity. Members of the committee would be appointed and removed by shareholders in the same manner as directors. A possible drawback to the effectiveness of such a committee is that the same majority that appoints the directors would be required to appoint members of the advisory committee.

In that respect the committee members may be viewed as non-executive directors with a different title especially as their compensation systems may be similar. An important difference between members of the proposed shareholders' advisory committee and non-executive directors is that the former, not being directors, can only review management decisions and not participate in the decision-making processes.

The existence of such a committee would create a forum for shareholders (especially institutional investors) to interact with their board. Having a greater say on key corporate issues would encourage institutional shareholders to see themselves as 'owners' and not simple 'investors'. Such an institutionally oriented committee may increase the incentive for large shareholders to be actively involved in controlling their companies. It would serve as a resource to the board while enhancing the relationship between the board of directors and the shareholders.

It can, however, be argued that the existence of a shareholder advisory committee would reduce the already limited power of individual shareholders. It should be remembered that the returns from the activities of such a committee would include higher dividends and price appreciation of shares which would be enjoyed by institutions and individual shareholders alike. The existence of mandatory shareholders' advisory committees may also be viewed as a step towards a two-tier board structure. The position would, however, be that employees would have no say in their composition in addition to the fact that members of such committees would not participate in any aspect of management.

Another criticism may be that it would create a structure which gives institutional investors uncontrollable powers just like the German banks. It has to be emphasised that with their large holdings institutions are in the best position, given the right legal framework and proper incentives, to work actively towards the long-term success of their companies.[27]

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27. One of the main reasons being that many of the blocks of shares held by institutional investors are too large to dispose of without depressing the market.

c) Powers Of The Shareholders' Advisory Committee

The proposed shareholders' advisory committees would have the power to oversee the proxy voting machinery of their companies. When compared with the U.S. proxy voting in the U.K. does not afford shareholders control of their companies. The regulation and prohibition of specific matters by the SEC Rules have enhanced the disclosure of information in proxy contests. If Shareholders' Advisory Committees were made mandatory they would ensure that adequate information is disclosed for shareholders who wish to vote by proxy.

Through such disclosures shareholder's would become aware of other shareholders who intend to attend specific general meetings. They would be given access to the corporate treasury for purposes of communicating with shareholders and financing proxy solicitations. Each committee would, therefore, provide a forum through which shareholders would effectively use the proxy machinery. They would also have the power to scrutinise and approve shares with disproportionate voting rights as very little has been done by way of regulating the issue of shares with disparate rights.[28]

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28. The London Stock Exchange simply requires the words "non-voting" to appear in the description of shares of that category - Admission of Securities to Listing 0.04 - it is silent on the issue of shares with multiple voting power.

Where a shareholder advisory committee is involved in scrutinising the issue of disproportionate voting shares, management would be unlikely, under the glare of shareholders' scrutiny, to make drastic shifts in voting control. Apart from these specific powers, advisory committees would have the power to call general meetings of shareholders to notify the shareholders of any aspect of mismanagement of the company. Once such actions are taken by the general meeting the committee would communicate the views and intentions of the shareholders to the board. In addition to these the committee would have power to scrutinise and review any transaction undertaken by the company which involves potential conflict of interests.

Members of the committee would be compensated for time expended on the company's business. They would be reimbursed for reasonable travel and other out-of-pocket expenses incurred in serving as committee members and these would include indemnification and advancement of expenses as would directors.

2. IMPROVING BOARD MONITORING

Some of the central responsibilities of company boards of directors are the formulation and implementation of business strategies on behalf of shareholders. Corporate control has moved in the direction of concentrating authority, in large companies, in the board of directors. The board of directors is at the very pivot of corporate governance. The Cadbury Report emphasised this in paragraph 2.5 where it states that: "Boards of directors are responsible for the governance of their companies." The board, and the way it functions, will largely be determine by its composition.

It has been recognised that even the present emphasis on the monitoring role of non-executive directors is fraud with problems. One of them being that non-executive directors are selected by the chief executive and simply have their appointments endorsed by the general meeting. The Cadbury Report recommended that non-executive directors should bring "an independent judgement to bear on issues of strategy, performance, and resources including key appointments and standards of conduct".[29]

The importance of the role of non-executive directors in representing shareholders interests has been recognised by all sectors. A clearer distinction between the roles of the executive and non-executive directors should, however, be made. Although this may give the impression that boards are divided into two sections on the German pattern, they would still operate on the same unitary board which this work favours retaining on balance. The following are suggestions which if implemented, would help company boards to monitor their companies more effectively.

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29. See para 4.1

a) Making A Certain Percentage Of Independent Non-Executive Directors Mandatory For Public Companies

It has been acknowledged that more emphasis is being placed on the importance of independent non-executive directors. The main reason being that this category of directors should not be dependent on the chief executive for promotion and, therefore, are relatively free from conflicts of interests. The Cadbury Report has simply recommended that company boards should include non-executive directors of sufficient calibre and number for their views to carry significant weight in board decisions.[30]

Taking into consideration the fact that boards vary in size according to the needs of different companies this work recommends that public companies be required to appoint non-executive directors to form at least half of their board. Where that is achieved independent non-executive directors would be in a position to make a meaningful contribution to the vital checks and balance mechanisms in their company. Where a proportion of non executive directors is determined by statute, it would ensure that the wide variation in the number of non-executive directors on boards of different companies would be reduced.

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30. See para 1.3 of the Cadbury Code of Best Practice

b) Limiting Interlocking Directorates

Chapter nine has shown that interlocking directorships have been a feature of the corporate scene with the effect that managers of one company serve to oversee the managers of another. This may create inter-corporate cohesion and relationships that undermine the independence of non-executive directors. More so interlocking directorates between companies in the same industry may forestall the development of competition which would occur in the normal expansion of each company.

Interlocks between manufacturing companies and banks may result in the granting of credit to favoured companies and refusal of credit to competitors. Where companies that are suppliers/ purchasers have common directors, this may result in preferential treatment where there is a short supply to the impairment of competition.

This work recommends that the number of board appointments that a person may hold be limited to three by law. Such a limitation would enhance monitoring as it would enable directors to make a significant commitment of time to the affairs of each company. A chief executive officer should not serve on any other board as the position requires total commitment and full-time input. Apart from lack of time, mutuality of interests and lack of competition that can be fostered by companies having common directors, there is a danger that such interlocks may result in a spiralling upward pay round.

c) An Improved Method Of Selecting And Training Directors

There have been recommendations both in the U. K. and U. S. that non-executive directors be independent by all standards. Where the Chief Executive picks the non-executive group and counts the votes at general meetings, directors are bound to feel that they owe the chief executive their loyalty. A better system of finding director candidates should be put in place. The Cadbury Committee recommended the establishment of nomination committees as a method of independent assessment but did not include that in the Code of Best Practice. In this respect all companies should be required by law to have nomination committees made up of non-executive directors.

The nomination committee should meet with the investors once a year to discuss the processes and criteria used to search for candidates. Such meetings would encourage the involvement of investors (especially institutional shareholders) in the search for candidates. Nomination committees should have access to independent professional agencies at the company's expense.

With the rate of changes in the business world, experience acquired five years prior to an appointment may become irrelevant at the time of appointment. In view of this an induction programme consisting of, among other things, talks with customers, competitors, auditors, managers, shareholders and employees, would enhance directors' understanding.

d) Mandatory Separation Of The Positions Of Chief Executive Officer and Chairman

The Cadbury Report had emphasised the role of the board chairman by stating that the chairman should be able to stand sufficiently back from the day to day running of the business.[31] Although the Cadbury's Code of Best Practice indicates that there should be a division of responsibilities at the head of a company to ensure a balance of power and authority,[32] it stops short of recommending this separation.

The title of chief executive officer has become linked with wide powers. One of the functions of the board (including the chairman) being the removal of the chief executive officer, this becomes difficult where the chief executive officer is also the board chairman.

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31. Para 4.7

32. Para. 1.2

Where there is a mandatory separation of these roles the chief executive officer would still have enough authority to make policy decisions while sufficient accountability would be made to the board for the benefit of shareholders. Where these positions are lumped into one there is a potential conflict between commitment to management and the need for a balanced view of the interests of shareholders.

A possible objection to a mandatory separation of these two roles may be that it has the tendency of generating infighting in the board thus weakening the leadership of the company. This objection would fail to take into consideration the fact that there are two distinct roles involved - managing the board of directors and managing the company. While the chief executive officer bears the full responsibility for managing the company, the chairman is responsible for managing the board.

e) The Mandatory Use Of Board Committees

Board committees such as audit, nomination and remuneration committees can provide a valuable way of increasing board efficiency. Although the delegation of specific business to board committees has been recommended by the Cadbury, Greenbury and Hampel Committees, there is no compulsion on companies to have such committees.

This work recommends that the use of the three major committees of the board - nomination, audit and remuneration committees - should be made mandatory for all public companies. As the nomination committee has already been discussed this part shall deal with the importance of the audit and remuneration committees.

On appointment, members of the audit committee should be given an induction training to understand their role as well as that of the auditors. Committee members cannot make the right decisions without appropriate information. Adequate and timely information is, therefore, essential for the proper working of these committees. Moreover, the way that committee members obtain their information will affect their knowledge and understanding of committee deliberations.

As indicated by the Cadbury and Greenbury Reports, the primary tasks of the remuneration committee should be to advise the board on remuneration policies and implement such policies. This committee should comprise of non-executive directors as executive directors should play no part in decisions on their own remuneration.[33] The Greenbury Report has not only recommended that boards should set up remuneration committees but has

33. As recommended by para 4.42 of the Cadbury Report

clearly stated that such committees should consist exclusively of non-executive directors.[34] It should draw up the remuneration report sections of the annual report and accounts.

This committee should give its opinion not only on the remuneration of board members, but should also have a distinct role in determining the performance-related share options and compensation of executive directors. The use of independent professional advice should be available to board committees as recommended by para. 1.5 of the Cadbury's Code of Best Practice but this should be co-ordinated by the non-executive chairman for purposes of checking extravagances. The Greenbury Report also stressed the importance of providing adequate support structures for remuneration committees, stating that they would need to draw on outside consultants to be in a position to make independent judgement on issues of directors' remuneration.[35]

3. JUDICIAL POWER TO REMOVE DIRECTORS ON THE APPLICATION OF MINORITY SHAREHOLDERS

Presently there is no judicial power to remove legally appointed directors in the U.K. even where there is evidence of dishonesty or inability to perform set

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34. Ibid para A4

35. Ibid para 4.17

down duties. As indicated in chapter 4 shareholders' power to remove directors by a majority vote may not be a practical remedy. The fact is that the majority shareholders may be in collusion with dishonest directors. A minority of shareholders (for instance 15%) should, therefore, be able to apply to the court to have a director removed from office on the grounds of fraud, dishonesty or some abuse of trust. If this right is given to the minority, the only requirement on their part would be that there exists sufficient cause for removal.

When such an application is filed, the director to be removed would be given adequate notice and afforded the opportunity to respond to the accusations. Even where a shareholders' agreement provides that a particular director shall be maintained in office *such an agreement* will be subject to an implied condition that the director will effectively perform the duties of the office. Under such a circumstance a director should still be removable by the court for any abuse of authority.

The right of minority shareholders to apply to court to have a director removed would put shareholders in a better position to determine the composition of their boards. It would bring U.K. shareholders in line with their U.S. counterparts who only need to hold 10% of the outstanding shares of any class to apply for the judicial removal of a director for cause. In the U.S. such a removal can also be at the instance of the state's attorney general.

This right as given to U.S. shareholders is usually provided for by state statutes.[36]

The fact that there is no equivalent provision under U.K. law is surprising in the light of the well-established power of equity to remove trustees for substantial cause such as misappropriation or breach of trust. Under the law of trust it is irrelevant that the breach of trust complained of is in any way connected with an agent. As the majority vote of shareholders required to remove directors in the U.K. may be difficult to obtain thoughts need to be given in this direction.

4. MORE STRINGENT RULES ON PROXY VOTING

Proxy voting in the U. K does not afford shareholders the required control in their companies. When compared to the U.S. where stringent regulations are put in place to prevent the abuse of the machinery, the present position in the U.K. leaves a lot to be desired. It can, therefore be said that the proxy voting system has superseded the shareholders' meeting itself. The result is that the outcome of contested issues will usually be a forgone conclusion. The regulation of specific matters with regard to proxy voting would enhance the use of this machinery by U.K. shareholders.

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36. Examples are Section 706(d) N.Y. Bus Corp. Law (McKinney 1986); Section 304 Cal. Corp. Code (West 1990) and Section 8.09 Revised Model Business Corp. Act 1984

Although the Stock Exchange Rules require a two-way proxy, which gives the shareholder the opportunity to direct the proxy whether to vote for or against the resolution, with the poor response of shareholders, management is still left in control of the machinery. In addition to that, as the listing rules are not statutory requirements they do not regulate all companies. Even the requirements of Articles 60 and 61 that there should be two forms of proxies still leave management in control of this machinery.[37]

Although the facility of proxy voting has given an appearance of shareholders' voting right being enhanced, this appearance is deceptive. For shareholders to instruct their proxies intelligently they need to be informed on corporate policies and existing alternatives. Shareholders need adequate information on both sides of the case to be able to exercise their voting rights properly.

Given that there are inadequate incentives for individual shareholders to undertake proxy context to oppose management, a legal rule requiring companies to reimburse insurgents may be a sensible way of obtaining shareholder involvement. This might also work to reduce the free rider problem. Rules should also be promulgated to make communication among shareholders possible.

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37. These two articles require that the first form should give the proxy complete discretion and the second form should be a two-way proxy which can be used to instruct the proxy on how to vote.

E) BENEFITS OF THE PROPOSED MODEL

It is believed that significant benefits would be derived from the implementation of these recommendations. There would be the creation of a closer bond between shareholders and corporate management with a greater focus on the long-term goals and interests of the company. Company performance and potential returns to shareholders would be improved as there would be an alignment of management actions with shareholders, interests. Shareholders would be well-informed through good, open communication and would have a clear understanding of their company's goals.

Apart from providing companies with a higher quality of non-executive directors who would also be better informed, the non-executive group would be truly independent of the executive team. Non-executive directors would have a deeper understanding of the key factors that would enable them to come to a judgement about the long-term strategic plans of the company. These better-qualified and independent non-executive directors would be in a good position to monitor the executive team for the protection of shareholders' interests.

APPENDIX A

REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (The Cadbury Report)

Companies to whom directed

3.1 The Code of Best Practice is directed to the boards of directors of all listed companies registered in the U.K. but we would encourage as many other companies as possible to aim at meeting its requirements.

Code Principles

3.2 The principles on which the Code is based are those of openess, integritv and accountability. They go together. Openness on the part of companies, within the limits set by their competitive position, is the basis for the confidence which needs to exist between business and all those who have a stake in its success. An open approach to the disclosure of information contributes to the efficient working of the market economy, prompts boards to take effective action and allows shareholders and others to scrutinise companies more thoroughly.

3.3 Integrity means both straightforward dealing and completeness. What is required of financial reporting is that it should be honest and that it should present a balanced picture of the state of the company's affairs. The integrity of reports depends on the integrity of those who prepare and present them.

3.4 Boards of directors are accountable to their shareholders and both have to play. their part in making that accountability effectively. Boards of directors need to do so through the quality of the information which they provide to shareholders, and shareholders through their willingness to exercise their responsibilities as owners.

3.5 The arguments for adhering to the Code are twofold. First, a clear understanding of responsibilities and an open approach to the way in which they have been discharged will assist boards of directors in framing and winning support for their strategies. It will also assist the efficient operation of capital markets and increase confidence in boards, auditors and financial reporting and hence the general level of confidence in business.

3.6 Second, if standards of financial reporting and of business conduct more generally are not seen to be raised, a greater reliance on regulation may be inevitable.

Statement of Compliance

3.7 We recommend that listed companies reporting in respect of years ending after 30 June 1993 should state in the report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance.

3.8 The London Stock Exchange intends to require such a statement as one of its continuing listing obligations. We envisage, however, that many companies will wish to go beyond the strict terms of the London Stock Exchange rule and make a general statement about the corporate governance of their enterprises as some leading companies have already done. We welcome such statements and leave it to boards to decide the terms in which they make their statement of compliance. Boards are not expected to comment separately on each, item, of the Code with which they are complying. but areas of non-compliance will have to be dealt with individually.

3.9 The continuing obligations laid down by the London Stock Exchange should require companies' statements of compliance to have been the subject of review by the auditors before publication. The review should cover only those parts of the compliance statement which relate to provisions of the Code where compliance can be objectively verified (see footnote to the Code,). The auditors should not be required to report formally a satisfactory conclusion to their review, but if they identify an area of non-compliance which is not properly disclosed, they should draw attention to it in their report on the financial statements. We recommend that the Auditing Practices Board should consider guidance for auditors accordingly.

3.10 The Code is to be followed by individuals and companies in the light of their own particular circumstances. They are responsible for ensuring that their actions meet the spirit of the Code and in interpreting it they should give precedence to substance over form.

Keeping the Code up to date

3.11 We have addressed those issues which appeared from the evidence before us to require the most immediate attention. The situation, however, is developing. The Accounting Standards Board has in hand a programme of work on the basis of financial reporting. Revised accounting standards and improved methods of financial presentation will result. At the same time, views on best boardroom practice will evolve in the light of experience. and European Communitv directives and regulations may give rise to new issues. It is essential, therefore, that the Code, in addition to being monitored, is kept up to date.

3.12 We recommend that our sponsors. convened by the Financial Reporting Council, should appoint a new Committee by the end of June 1995 to examine how far compliance with the Code has progressed. how far our other recommendations have been implemented, and whether the Code needs updating in line with emerging issues. Our sponsors should also determine whether the sponsorship of the new Committee should be broadened and whether wider matters of corporate governance should be included in its brief. In the meantime. the present Committee will remain responsible for reviewing the implementation of its proposals and for identifying further issues which its successor body might usefully consider. These steps will establish a continuing process of governance review.

Compliance

3.13 Raising standards of corporate governance cannot be achieved by structures and rules alone. They are important because they provide a framework which will encourage and support good governance, but what counts is the way in which they are put to use.

3.14 The responsibility for putting the Code into practice lies directly with the boards of directors of listed companies to whom it is addressed. Compliance itself, however. is a matter for everyone concerned with corporate Governance. We look to the financial institutions and the wide range of bodies backing our work to encourage the adoption of our recommendations by companies in which they have an interest. The media also have a part to play in drawing attention to governance issues of public or shareholder concern. It is vital to seize the opportunity presented by a climate of opinion which accepts that changes are needed and which is expecting the Committee to give the necessary lead.

3.15 The Committee recognises that smaller listed companies may initially have difficulty in complying with some aspects of the Code and we have given careful consideration to the responses to the draft report which addressed this point. The boards of smaller listed companies who cannot, for the time being. comply with parts of the Code should note that they may instead give their reasons for non compliance. We believe, however. that full compliance will brine benefits to the boards of such companies and it should be their objective to ensure that the benefits are achieved. In particular. the appointment of appropriate non-executive directors should make a positive contribution to the development of their businesses. Any practical issues which may arise in respect of smaller listed companies will be thoroughly reviewed b., the Committee and its successor.

3.16 The Committee notes that companies will not be able to comply with items 4.5 and 4.6 in the Code until the necessary <u>guidance</u> for companies has been developed.

Board Effectiveness

4.1 Every public company should be headed by an effective board which can both lead and control the business. Within the context of the UK unitary. board system, this means a board made up of a combination of executive directors., with their intimate knowledge of the business, and of outside. non-executive directors, who can bring a broader view to the company's activities, under a chairman who accepts the duties and responsibilities which the post entails.

4.2 Tests of board effectiveness include the way in which the members of the board as a whole work together under the chairman, whose role in corporate governance is fundamental. and their collective ability to provide both the leadership and the checks and balances which effective governance demands. Shareholders are responsible for electing board members and it is in their interests to see that the boards of their companies are properly constituted and not dominated by any one individual.

4.3 All directors are equally responsible in law for the board's actions and decisions. Certain directors may have particular responsibilities. as executive or non-executive directors, for which they are accountable to the board. Regardless of specific duties undertaken by individual directors, however, it is for the board collectively to ensure that it is meeting its obligations.

4.4 Whilst it is the board as a whole which is the final authority, executive and non-executive directors are likely to contribute in different ways to its work. Non-executive directors have two particularly important contributions to make to the governance process as a consequence of their independence from executive responsibility. Neither is in conflict with the unitary nature of the board.

4.5 The first is in reviewing the performance of the board and of the executive. Non-executive directors should address this aspect of their responsibilities carefully and should ensure that the chairman is aware of their views. If the effectiveness of the board. A number of companies have recognised that role and some have done so formally in their Articles.

4.6 The second is in taking the lead where potential conflicts of interest arise. An important aspect of effective corporate governance is the recognition that the specific interests of the executive management and the wider interests of the company may at times diverge, for example over take-overs, boardroom succession, or directors' pay Independent non-executive directors whose interests are less directly affected, are well-placed to help to resolve such situations.

The Chairman

4.7 The chairman's role in securing good corporate governance is crucial. Chairmen are primarily responsible for the working of the board, for its balance of membership subject to ' board and shareholders' approval, for ensuring, that all relevant issues are on the agenda. and for ensuring that all directors, executive and non-executive alike, are enabled and encouraged to play their full part in its activities. Chairmen should be able to stand sufficiently back from the day-to-day. running of the business to ensure that their boards are in full control of the company's affairs and alert to their obligations to their shareholders.

4.8 It is for chairmen to make certain that their non-executive directors receive timely, relevant information tailored to their needs. that they are properly briefed on the issues arising at board meetings. and that they make an effective contribution as board members in practice. It is equally for chairmen to ensure that executive directors look beyond their executive duties and accept their full share of the responsibilities of governance.

4.9 Given the importance and particular nature of the chairman's role. it should in principle be separate from that of the chief executive. If the two roles are combined in one person, it represents a considerable concentration of power. We recommend, therefore, that there should be a clearly acceptable division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board

Non-Executive Directors

4.10 The Committee believes that the calibre of non-executive members of the board is of special importance in setting and maintaining standards of corporate governance. The emphasis in this report on the control function of non-executive directors is a consequence of our remit and should not in any way detract from the primary and positive contribution which they are expected to make. as equal board members, to the leadership of the company.

4.11 Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources. including key appointments. and standards of conduct. We recommend that the calibre and number of non-executive directors on a board should be such that their views will carry significant weight in the board's decisions. To meet our recommendations on the composition of sub-committees of the board. all boards will require a minimum of three non-executive directors, one of whom may be the chairman of the company provided he or she is not also its executive head. Additionally. two of the three should be independent in the terms set out in the next paragraph.

4.12 An essential quality which non-executive directors should bring. to the board's deliberations is that of independence of judgement. We recommend that the majority of non-executives on a board should be independent of the company. This means that apart from their directors' fees and shareholdings, they should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. It is for the board to decide in particular cases whether this definition is met. Information about the relevant interests of directors should be disclosed in the Directors' Report.

4.13 On fees. there is a balance to be struck between recognising the value of the contribution made by non-executive directors and not undermining their independence. The demands which are now being made on conscientious non-executive directors are significant and their fees should reflect the time which they devote to the company's affairs. There is. therefore. a case for paying for additional responsibilities taken on. for example, by chairmen of board committees. In order to safeguard their independent position. we regard it as good practice for non-executive directors not to participate in share option schemes and for their service as non-executive directors not to be pensionable by the company.

4.14 Non-executive directors lack the inside knowledge of the company of the executive directors, but have the same right of access to information as they do. Their effectiveness turns to a considerable extent on the quality of the information which they receive and on the use which they make of it. Boards should regularly review the form and the extent of the information which is provided to all directors.

4.15 Given the importance of their distinctive contribution, non-executive directors should be selected with the same impartiality and care as senior executives. We recommend that their appointment should be a matter for the board as a whole and that there should be a formal selection process which will reinforce the independence of non-executive directors and make it evident that they have been appointed on merit and not through any form of patronage. We regard it as good practice for a nomination committee (dealt with below) to carry out the selection process and to make proposals to the board.

4.16 Companies have to be able to bring about changes in the composition of their boards to maintain their vitality. Non-executive directors may lose something of their independent edge. if they remain on a board too long. Furthermore, the make-up of a board needs to change in line with new challenges. We recommend, therefore, that non-executive directors should be appointed for specified terms. Their Letter of Appointment should set out their duties. term of office, remuneration and its review. Reappointment should not be automatic, but a conscious decision by the board and the director concerned.

4.17 Our emphasis on the qualities to be looked for in non-executive directors, combined with the greater demands now being, made on them, raises the question of whether the supply of non-executive directors, combined with the greater demand now being made on them, raises the question of whether the supply of non-executive directors will be adequate to meet the demand. When companies encourage their executive directors to accept appointments on the boards of other companies, the companies and the individuals concerned all gain. A policy of promoting this kind of appointment will increase the pool of potential non-executive directors, particularly if the divisional directors of larger companies are considered for non-executive posts, as well as their main board colleagues.

Professional Advice

4.18 Occasions may arise when directors have to seek legal or financial advice in the furtherance of their duties. They should always be able to consult the company's advisers. If, however, they consider it necessary to take independent professional advice, we recommend that they should be entitled to do so at the company's expense, through an agreed procedure laid down formally, for example in a Board Resolution, in the Articles, or in the Letter of Appointment.

Directors' Training

4.19 The weight of responsibility carried by all directors and the increasing commitment which their duties require emphasise the importance of the way in which they prepare themselves for their posts. Given the varying backgrounds. qualifications and experience of director;, it is' highly desirable that they should all undertake some form of internal or external training: this is particularly important for directors. whether executive or non-executive. with no previous board experience. Newly-appointed board members are also entitled to expect a proper process of induction into the company's affairs. It is then up to individual directors to keep abreast of their legislative and broader responsibilities.

4.20 There are already courses for newly-appointed directors run by the Institute of Directors and business schools. With the support of the Bank of England, the Confederation of British Industry, the Institute of Directors, and PRO NED, a new course covering the fu11 range of board responsibilities will be open to directors shortly. The training and development of directors is of importance to good governance and it is one of the issues which we suggest our successor body should keep under review.

Board Structures and Procedures

4.21 The effectiveness of a board is buttressed by and procedures. One aspect of structure is the appointment of committees of the board. such as audit, remuneration and nomination committees.

4.22 Another is that boards should recognise the importance of the finance function by making it the responsibility of a main board director, who should be a signatory to the account on behalf of the board and should have the right of access to the Audit Committee.

4.23 The basic procedural requirements are that the board should meet regularly, with due notice of the issues to be discussed supported by the necessary paperwork, and should record its conclusions. We recommend that boards should have a formal schedule of matters specifically reserved to them for their collective decision to ensure that the direction and control of the company remains firmly in their hands and as a safeguard misjudgements and possible illegal practices. A Schedule of these matters should be given to directors, on appointment and should be kept up to date.

4.24 We envisage that such a schedule would at least include:

(a) acquisition and disposal of assets of the company or its subsidiaries that are material to the company,:
(b) investments, capital projects, authority levels, treasury policies, and risk management policies.

Boards should lay down rules to determine materiality for any transaction, and should establish clearly which transactions require multiple board signatures. Boards should also agree the procedures to be followed when exceptionally decisions are required between board meetings.

The Company Secretary

4.24 The company secretary has a key role to play in ensuring that board procedures are both followed and regularly reviewed. The chairman and the board will look t company secretary for guidance on what their responsibilities are under the rules and regulations to which they are subject and on how those responsibilities

Nomination Committees

4.30 One approach to making board appointments, which makes clear how these appointments are made and assists boards in making them, is through the setting up of a nomination committee, with the responsibility of proposing to the board, in the first instance, any new appointments, whether of executive or of non-executive directors. A nomination committee should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director.

Internal Controls

4.31 Directors are responsible under s.221 of the Companies Act 1985 for maintaining adequate accounting records. To meet these responsibilities directors need in practice to maintain a system of internal control over the financial management of the company, including procedures designed to minimise the risk of fraud. There is, therefore, already an implicit requirement on directors to ensure that a proper system of internal control is in place.

4.32 Since an effective internal control system is a key aspect of the efficient management of a company. we recommend that the directors should make a statement in the report and account on the effectiveness of their system of internal control add that the auditors should report thereon.

Audit Committees

4.33 Since 1978. the New York Stock Exchange has required all listed companies to have audit committees composed solely of independent directors and the 1987 report of the American Law Commission concluded that audit committees had a critical role to play in ensuring the integrity of US company financial reports. While experience of audit committees in this country is shorter, it is encouraging, and around two-thirds of the top 250 U.K. listed companies now have them in place.

4.34 Experience in the United States has shown that, even where audit committees might have been set up mainly to meet listing requirements. they have proved their worth and developed into essential committees of the board. Similarly, recently published research in the United Kingdom concludes that the majority of companies with audit committees are enthusiastic about their value to their businesses. They offer added assurance to the shareholders that the auditors, who act on their behalf, are in a position to safeguard their interests.

4.35 The Committee therefore recommends that all listed companies should establish an audit committee. Our further recommendations on audit committees are as follows:

(a) Audit committees should be formally constituted to ensure that they have a clear relationship with the boards to whom they are answerable and to whom they should report regularly. They should be given written terms of reference which deal adequately, with their membership, authority and duties, and they should normally meet at least twice a year.

(b) There should be a minimum of three members. Membership should be confined to the non-executive directors of the company and a majority of the non-executives serving on the committee should be independent, as defined in paragraph 4. 12 above. Membership of the committee should be disclosed in the annual report.

(c) The external auditor should normally attend audit committee meetings, as should the finance director. As the board as a whole is responsible for the financial statements, other board members should also have the right to attend. The committee should have a discussion with the external auditors, at least once a year, without executive board members present, to ensure that there are no unresolved issues of concern.

(d) The audit committee should have explicit authority to investigate any matters within its terms of reference. the resources which it needs to do so, and full access to information. The committee should be able to obtain external professional advice and to invite outsiders with relevant experience to attend if necessary.

(e) The audit committee's duty should be determined in the light of the company's need but should normally include:

(i) making recommendations to the board on the appointment of the external auditor. the audit fee, and any questions of resignation or dismissal:

(ii) review of the half-year and annual financial statements before submission to the board:

(iii) discussion with the external auditor about the nature and scope of the audit, co-ordination where more than one audit firm is involved, any problems or reservations arising from the audit. and any matters which the external auditor wishes to discuss, without executive board members present;

(iv) review of the external auditor's management letter;

(v) review of the company's statement on internal control systems prior to endorsement by the board;

(vi) review of any significant findings of internal investigations.

(f) Where an internal audit function exists. the audit committee should ensure that it is adequately resourced and has appropriate standing within the company. The internal audit programme should be in reviewed b the audit committee, and the head of internal audit should normally attend its meetings.

(g) The chairman of the audit committee should be available to answer questions about its work at the Annual General Meeting.

4.36 The Committee believes that boards should appoint audit committees, rather than aiming to carry out their functions themselves. A separate audit committee enables a board to delegate to a sub-committee a thorough and detailed review of audit matters, it enables the non-executive directors to contribute an independent judgement and play a positive role in an area for which they are particularly fitted, and it offers the auditors a direct link with the non-executive directors. The ultimate responsibility of the board for reviewing and approving the annual report and accounts and the half-year report remains undiminished by the appointment of an audit committee, but it provides an important assurance that a key area of a board's duties will be rigorously discharged.

4.37 The Committee therefore regards the appointment Of properly constituted audit committees as an important step in raisins standards of corporate Governance. Their effectiveness depends on their having a strong chairman who has the confidence of the board and of the auditors. and on the quality of the non-executive directors. Membership of an audit committee is a demanding task requiring commitment, training and skill. The directors concerned need to have sufficient understanding of the issues to be dealt with by the committee to take an active part in its proceedings. This is why committees should, if it is appropriate and within their authority, be able to invite outsiders with relevant experience to attend meetings.

4.38 The external auditors should be present at the board meeting when the annual report and accounts are approved and preferably when the half-yearly report is considered as well.

Internal Audit

4.39 The function of the internal auditors is complementary to, but different from, that of the outside auditors. We regard it as good practice for companies to establish internal audit functions to undertake regular monitoring of key controls and procedures. Such regular monitoring is an integral part of a company's system of internal control and helps to ensure its effectiveness. An internal audit function is well placed to undertake investigations on behalf of the audit committee and to follow up any suspicion of fraud. It is essential that heads of internal audit should have unrestricted access to the chairman of the audit committee in order to ensure the independence of their position.

Board Remuneration

4.40 The overriding principle in respect of board remuneration is that of openness. Shareholders are entitled to a full and clear statement of directors' present and future benefits, and of how they have been determined. We recommend that in disclosing directors' total emoluments and those of the chairman and highest-paid UK director, separate figures should be given for their salary and performance-related elements and that the criteria on which performance is measured should be explained. Relevant information about stock options, stock appreciation rights, and pension contributions should also be given.

4.41 In addition, we recommend that future service contracts should not exceed three years without shareholders' approval and that the Companies Act should be amended in line with this recommendation. This would strengthen shareholder control over levels of compensation for loss of office.

4.42 We also recommend that boards should appoint remuneration committees. consisting wholly or mainly of non-executive directors and chaired by a non-executive director. to recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary. Executive directors should play no part in decisions on their own remuneration. Membership of the remuneration committee should appear in the Directors' Report. Best practice in this field is set out in PRO NED's Remuneration Committee guidelines, published in 1992.

4.43 The Committee has received proposals for giving shareholders the opportunity to determine matters such as directors' pay at general meetings. but does not see how these suggestions could be made workable. A director's remuneration is not a matter which can be sensibly reduced to a vote for or against; were the vote to go against a particular remuneration package, the board would still have to determine the remuneration of the director concerned. In addition, there are such practical considerations as the need to agree directors' remuneration on appointment.

4.44 Shareholders require that the remuneration of directors should be both fair and competitive. Striking this balance involves detailed consideration of the kind which a remuneration committee, whose members have no personal interest in the outcome, can give to the matter. Remuneration committees need to have the interests of the company and the shareholders always in mind in coming to their decisions and the chairman of the committee should be available to respond to any concerns of shareholders at the Annual General Meeting.

4.45 The Annual General Meeting, provides the opportunity for shareholders to make their views on such matters as directors' benefits known to their boards. It is the Committee's view that shareholders can play a more practical governance role by aiming to influence board policies in this way, than by seeking to make the detail of board decisions subject to their vote.

4.46 Further changes to the rules for disclosure. such as lengthening the list of directors whose remuneration is individually identified, and the role which shareholders could play. either in voting on particular aspects of remuneration or in tabling advisory resolutions along lines now developing in the USA, will need to be reviewed in the light of experience. Directors' contracts and pay are aspects of board accountability which the Committee will continue to monitor in the expectation that they will be on the agenda of our successor body.

Financial Reports

4.47 A basic weakness in the current system of financial reporting is the possibility of different accounting treatments being applied to essentially the same facts, with the consequence that different results or financial positions could be reported, each apparently complying with the overriding requirement to show a true and fair view. Regardless of how far the market can understand the implications of alternative accounting treatments or see through presentational techniques designed to show company's figures in the most flattering light, there are advantages to investors. analysts, other accounts users and ultimately to the company itself in financial reporting rules which limit the scope for uncertainty and manipulation.

4.48 The lifeblood of markets is information and barriers to the flow of relevant information represent imperfections in the market. The need to sift and correct the information put out by companies adds cost and uncertainty to the market's pricing function. The more the activities of companies are transparent. the more accurately will their securities be valued.

4.49 In addition, the wider the scope for alternative treatments, the less useful financial reports become in terms of comparability - over time and between companies.

4.50 What shareholders (and others) need from the report and accounts is a coherent narrative, supported by the figures, of the company's performance and prospects. We recommend that boards should pay particular attention to their duty to present a balanced and understandable assessment of their company's position. Balance requires that setbacks should be dealt with as well as successes, while the need for the report to be readily understood emphasises that words are as important as figures.

4.51 The cardinal principle of financial reporting is that the view presented should be true and fair. Further principles
are that boards should aim for the highest of disclosure consonant with presenting reports which are understandable and with avoiding damage to their competitive position. They should also aim to ensure the and consistency of their reports and the,. should meet the spirit as well as the letter of reporting standards.

4.52 The Committee wholeheartedly endorses the objectives of the Financial Reporting Council and the Accounting Standards Board in setting reporting standards. It also welcomes the action being taken by the Financial Reporting Review Panel over companies whose accounts fall below accepted reporting standards.

4.53 The Committee recognises the advantage to users of reports and accounts of some explanation of the factors likely to influence their company's future progress. The inclusion of an essentially forward-looking Operating and Financial Review, along the lines developed by the Accounting Standards Board for Consultation, would serve this purpose.

Reporting Practice

4.54 Listed companies publish full financial statements annually and half-yearly reports in the interim. In between these major announcements. boards may need to keep shareholders and the market in touch with their company's progress. The guiding principle once again is openness and boards should aim for any intervening statements to be widely circulated, in fairness to individual shareholders and to minimise the possibility of insider trading.

4.55 If companies reported quarterly, the need for more informal methods of keeping investors informed would be diminished. Quarterly reporting would, however, involve additional costs for companies and ultimately for their shareholders and has not been recommended to us by shareholder bodies, who accept the present pattern of reporting by boards.

4.56 We consider that interim reports should be expanded in order to increase their value to users. We recommend that:

(a) balance sheet information should be included with the interim report. There should not be a requirement for a full audit. but the interim report should be reviewed by the auditors, who should discuss their findings with the audit committee;

(b) the continuing obligations laid down by the London Stock Exchange on UK companies admitted to listing should be amended to that effect and the Auditing Practices Board should develop appropriate review guidance;

(c) the Accounting. Standards Board in conjunction with the London Stock Exchange should clarify, the accounting principles which companies should follow in preparing interim reports;

(d) a requirement for inclusion of cash flow information in interim reports should be considered by our successor body.

4.57 Research has shown that the most widely read part of company reports is the opening statement, normally by the chairman. It is therefore of special importance that it should provide a balanced and readable summary of the company's performance and prospects and that it should represent the collective view of the board.

4.58 The demand for an ever-increasing, amount of detail in reports and accounts has to be weighed against the need for them to be understandable by the reasonably informed shareholder. Simplified forms of report. including the shortened version of the accounts. allow boards to address shareholders who would prefer such a statement, but make the need for the assessment to be balanced even more exacting.

4.59 Although a company's published reports and its Annual General Meeting are its primary channels of communication with shareholders, companies and their major shareholders may need to be in touch more frequently. The Institutional Shareholders' Committee's Statement on the Responsibilities of Institutional Shareholders gives practical guidance on how shareholders can best exercise their responsibilities as owners in this regard. We fully endorse their recommendation that there should be regular contact between companies and their major institutional shareholders at senior level and that such matters as board strategy and structure should be kept under review.

Pensions Governance

4.60 There are governance issues relating to company pension funds, highlighted by the Maxwell affair. but they fall within the remit of the Pension Law Review Committee under the chairmanship of Professor Goode, which is currently reviewing the framework of pension fund legislation and regulation. In the light of this. The Committee decided that it would be inappropriate for it to deal specifically with pension fund Governance issues.

Accountability of Boards to Shareholders

6.1 The formal relationship, between the *shareholders and the board of directors is that* the shareholders. elect the directors, the directors report on their stewardship to the shareholders and the shareholders appoint the auditors to provide external check on the directors' financial statements. Thus the shareholders as owners of the company elect the directors to run the business on their behalf and hold them accountable for its progress. The issue for corporate governance is how to strengthen the accountability of boards of directors to shareholders.

6.2 A number of proposals addressing this issue were put forward by individual shareholders and shareholder organisations. One was that shareholders should be more closely involved in the appointment of directors and auditors through the formation of shareholders' committees. Other proposals were directed at making it easier for shareholders, individually or collectively. to put forward resolutions at general meetings.

6.3 On the first proposal. we have not seen evidence explaining how it would be possible to form shareholder committees in such a way, that they would be both truly representative of all the company's shareholders and able to keep in regular touch with their changing constituencies. Unless these tests of legitimacy. are met, the Committee is unable to see how shareholder committees can become the accepted link between a board and its shareholders.

6.4 The second set of proposals raises such questions as what legislation would be needed to alter the present thresholds for tabling shareholder resolutions, and where the costs involved in circulating shareholder communications should fall. How far these suggestions are followed up should depend. in the Committee's view, on the degree of support which they command from the shareholder body as a whole. This may be a matter which our successor body will wish to review.

6.5 In the meantime, shareholders can make their vigils known to the boards of the companies in which they have invested by communicating with them direct and through their attendance at general meetings. Shareholder organisations set up to represent shareholder interests generally may provide individual shareholders with the choice of acting collectively in the case of particular companies if they prefer.

6.6 Shareholders have delegated many of their responsibilities as owners to the directors who act as their stewards. It is for the shareholders to call the directors to book if they appear to be failing in their stewardship and they should use this power. While they cannot be involved in the direction and management of their company. they can insist on a high standard of corporate governance and good governance is an essential test of the directors' stewardship. The accountability of boards to shareholders will. therefore, be strengthened if shareholders require their companies to comply with the Code.

6.7 Reports and accounts are presented to shareholders at the Annual General Meeting, when they have the opportunity to comment on them and to put their questions. In particular, the Annual General Meeting gives all shareholders, whatever the size of their shareholding, direct and public access to their boards. If too many Annual General Meetings are at present an opportunity missed, this is because shareholders do not make the most of them and, in some cases, boards do not encourage them to do so.

6.8 In the Committee's view, both shareholders and boards of directors should consider how the effectiveness of general meetings could be increased and as a result the accountability of boards to all their shareholders strengthened. Possible ways forward include providing forms in annual reports on which shareholders could send in written questions in advance of the meeting. in addition to their opportunity to ask questions at the meeting itself, and the circulation of a brief summary of points raised at the Annual General Meeting to all shareholders after the event. Consideration might also be given to ways of boards keeping in touch with their shareholders, outside the annual and half-yearly reports. The Committee encourages boards to experiment with ways of improving their links with shareholders along the above lines and shareholders to put proposals to their boards to the same end.

Institutional Shareholders

6.9 The proportion of shares held by individuals and by institutions has broadly reversed over the last thirty years, so that institutional shareholders now own the majority of shares of quoted companies. They are, however, largely holding their shares on behalf of individuals, as members of pension funds, holders of insurance policies and the like. As a result, there is an important degree of common interest between individual and institutional shareholders. In particular, both have the same stake in the standards of financial reporting and of Governance in the companies in which they have invested.

6.10 Given the weight of their votes, the way in which institutional shareholders use their power to influence the standards of corporate Governance is of fundamental importance. Their readiness to do this turns on the degree to which they see it as their responsibility as owners, and in the interest of those whose money they are investing, to bring about changes in companies when necessary, rather than selling their shares.

6.11 The Committee, therefore. warmly. welcomes the statement recently published by the Institutional Shareholders' Committee on the Responsibilities of Institutional Shareholders in the UK and we draw attention to three key conclusions which are basic to the development of a constructive relationship between companies and their owners.

1. Institutional investors should encourage regular. systematic contact at senior executive level to exchange views and information on strategy performance, board membership and quality of management.

2. Institutional investors should make positive use of their voting rights, unless they have good reason for doing, otherwise. They should register their votes wherever possible on a regular basis.

3 Institutional investors should take a positive interest in the composition of boards of directors, with particular reference to concentrations of decision-making power not formally constrained by appropriate checks and balances. and to the appointment of a core of non-executive directors of the necessary calibre, experience and independence.

6.12 The Institutional Shareholders' Committee's advice to its members to use their voting rights positively is important in the context of corporate Governance. Voting rights can be regarded as an asset, and the use or otherwise of those rights by institutional shareholders is a subject of legitimate interest to those on whose behalf they invest. We recommend that institutional investors should disclose their policies on the use of voting rights.

Shareholder Communications

6.13 These conclusions on the role of institutional shareholders raise issues over the lines of communication between boards and their shareholders. The first issue is one of parity between shareholders. The institutions are in a position to keep in touch with the boards of the companies in which they have invested. in a way which is not feasible for the individual shareholder. It is not possible in this respect to put both classes of shareholder on the same footing. What boards must do, however, is to ensure that any significant statements concerning their companies are made publicly and so are equally available to all shareholders.

6.14 A second issue which arises over communications between institutional investors and companies is the danger of imparting inside information. If price-sensitive information is to be given (and it is the company's responsibility to decide what might be price-sensitive), it must only be with the prior consent of the shareholder, who will then be unable to deal in the company's shares until that information has been made public. It is for shareholders to decide whether their longer-term interests are impaired by becoming, insiders, because of the short-term constraints on share dealing, which that position imposes.

6.15 If long-term relationships are to be developed, it is important that companies should communicate their strategies to their major shareholders and that their shareholders should understand them. It is equally important that shareholders should play their part in the communication process by informing companies if there are aspects of the business which give them cause for concern. Both shareholders and directors have to contribute to the building of a sound working relationship between them.

Shareholder Influence

6.16 Because of the importance of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders' Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the Code. The widespread adoption of our recommendations will turn in large measure on the support which all shareholders give to them. The obligation on companies to state how far they comply with the Code provides institutional and individual shareholders with a ready-made agenda for their representations to boards.

It is up to them to put it to good use. The Committee is primarily looking to such market-based regulation to turn its proposals into action.

APPENDIX B

AMERICAN LAW INSTITUTE'S, PRINCIPLES OF CORPORATE GOVERNANCE

PART 111
CORPORATE STRUCTURE:
FUNCTIONS AN POWERS OF DIRECTORS AND OFFICERS;
AUDIT COMMITTEE IN LARGE PUBLICLY HELD CPORPORATION

ANALYSIS AND RECOMMENDATION

§ 3.01 Management of the Corporation's Business:
Functions and Powers of Principal Senior Executives and Other Officers

The management of the business of a publicly held corporation should be conducted by or under the supervision of such principal senior executives as are designated by the board of directors, and by those other officers and employees to whom the management function is delegated by the board or those executives, subject to the functions and powers of the board under § 3.02.

§ 3.02 Functions and Powers of the Board of Directors

Except as otherwise provided by statute:

(a) The board of directors of a publicly held corporation should perform the following functions:

(1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives;
(2) Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed;
(3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions;
(4) Review and, where appropriate, approve major changes in, and determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements;
(5) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation

(b) A board of directors also has power to:

(1) Initiate and adopt corporate plans, commitments, and actions;
(2) Initiate and adopt changes in accounting principles and practices;

(3) Provide advice and counsel to the principal senior executives;
(4) Instruct any committee, principal senior executive or other officer and review the actions of any committee, principal senior executive, or other officer;
(5) Make recommendations to shareholders;
(6) Manage the business of the corporation;
(7) Act as to all other corporate matters not requiring shareholder approval.

(c) Subject to the board's ultimate responsibility for oversight under Subsection (a)(2), the board may delegate to its committees authority to perform any of its functions and exercise any of its powers.

§ 3.03 Directors' Informational Rights

(*a*) *Every director has* the right, within the limits of § 3.03(b) (and subject to other applicable law), to inspect and copy *all books, records, and documents* of every kind, and to inspect the physical properties, of the corporation and of *its subsidiaries*, domestic or foreign, at any reasonable time, in person or by an attorney or other agent.

(b) (1) A judicial order to enforce such right should be granted unless the corporation establishes that the information to be obtained by the exercise of the right is not reasonably related to the performance of directorial functions and duties, or that the director or the director's agent is likely to use the information in a manner that would violate the director's fiduciary obligation to the corporation.

(2) An application for such an order should be decided expeditiously and may be decided on the basis of affidavits.

(3) Such an order may contain provisions protecting the corporation from undue burden or expense, and prohibiting the director from using the information in a manner that would violate the director's fiduciary obligation to the corporation.

(4) A director who makes an application for such an order after the corporation has denied a request should, if successful, be reimbursed by the corporation for expenses (including attorney's fees) reasonably incurred in connection with the application.

ANALYSIS AND RECOMMENDATION

§ 3.04 Right of Directors Who Have No Significant Relation-ship with the Corporation's Senior Executives to Retain Outside Experts

The directors of a publicly held corporation who have no significant relationship with the corporation's senior executives should be entitled, acting as a body by the vote of a majority of such directors, to retain legal counsel, accountants, or other experts, at the corporation's expense, to advise them on problems arising in the exercise of their functions and powers, if..

(a) Payment of such expense is authorised by the board; or

(b) A court approves an application for the payment of such expense upon a finding that the board had been requested to authorise the payment of such expense and had declined to do so, and the directors who have no relationship with the corporation's senior executives reasonably believed that (i) retention of an outside expert was required for the proper performance of the directors' functions and powers, (ii) the amount involved was reasonable in relation to both the importance of the problem and the corporation's assets and income, and (iii) assistance by corporate staff or corporate counsel was inappropriate or inadequate.

§ 3.05 Audit Committee in Large Publicly Held Corporation

Every large publicly held corporation should have an audit committee to implement and support the oversight function of the board by reviewing on a periodic basis the corporation's processes for producing financial data, its internal controls, and the independence of the corporation's external auditor. The audit committee should consist of at least three members, and should be composed exclusively of directors who are neither employed by the corporation nor were so employed within the two preceding years, including at least a majority of members who have no significant relationship [§ 1.341 with the corporation's senior executives.

PART III-A

ANALYSIS AND RECOMMENDATION

§ 3A.01 Composition of the Board in Publicly Held Corporations

It is recommended as a matter of corporate practice that:
(a) The board of every large publicly held corporation should have a majority of directors who are free of any significant relationship with the corporation's senior executives unless a majority of the corporation's voting securities are owned by a single person, a family group, or a control group.
(b) The board of a publicly held corporation that does not fall within Subsection (a) should have at least three directors who are free of any significant relationship with the corporation's senior executives.*

§ 3A.02 Audit Committee in Small Publicly Held Corporations

It is recommended as a matter of corporate practice that every small publicly held corporation should have an audit committee to implement and support the oversight function of the board by reviewing on a periodic basis the corporation's processes for producing financial data, its internal controls, and the independence of the corporation's external auditor. The audit committee should consist of at least three members, and should be composed exclusively of directors who are neither employed by the corporation nor were so employed within the previous two years, including a majority of members who have no significant relationship with the corporation's senior executives.

§ 3A.03 Functions and Powers of Audit Committees

t is recommended as a matter of corporate practice that:

The audit committee of a publicly held corporation established under §§ 3.05 (Audit Committee in Large Publicly Held Corporations) or 3A.02 (Audit Committee in Small Publicly Held Corporations) should:

(a) Recommend the firm to be employed as the corporation's external auditor and review the proposed discharge of any such firm;

(b) Review the external auditor's compensation, the proposed terms of its engagement, and its independence;

(c) Review the appointment and replacement of the senior internal auditing executive, if any;

(d) Serve as a channel of communication between the external auditor and the board and between the senior internal auditing executive, if any, and the board.

(e) Review the results of each external audit of the corporation, the report of the audit, any related management letter, management's responses to recommendations made by the external auditor in connection with the audit, reports of the internal auditing department that are material to the corporation as a whole, and management's responses to those reports;

(f) Review the corporation's annual financial statements, any certification, report, opinion, or review rendered by the external auditor in connection with those financial statements, and any significant disputes between management and the external auditor that arose in connection with the preparation of those financial statements;

(g) Consider, in consultation with the external auditor and the senior internal auditing executive, if any, the adequacy of the corporation's internal controls;

(h) Consider major changes and other major questions of choice respecting the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements, when presented by the external auditor, a principal senior executive [§ 1.30], or otherwise.

§ 3A.04 Nominating Committee in Publicly Held Corporations: Composition, Powers, and Functions

It is recommended as a matter of corporate practice that:

(a) Every publicly held corporation, except corporations a majority of whose voting securities are owned by a single person, a family group, or a control group [§ 1.091, should establish a nominating committee composed exclusively of directors who are not officers or employees of the corporation, including at least a majority of members who have no significant relationship with the corporation's senior executives.

(b) The nominating committee should:

(1) Recommend to the board candidates for all directorships to be filled by the shareholders or the board.

(2) Consider, in making its recommendations, candidates for directorships proposed by the chief executive officer and, within the bounds of practicability, by any other senior executive or any director or shareholder.

(3) Recommend to the board directors to fill the seats on board committees.

3A.05 Compensation Committee in Large Publicly Held Corporations:
Composition, Powers, and Functions

It is recommended as a matter of corporate practice that:

(a) Every large publicly held corporation should establish a compensation committee to implement and support the oversight function of the board in the area of compensation. The committee should be composed exclusively of directors who are not officers or employees of the corporation, including at least a majority of members who have no significant relationship with the corporation's senior executives.

(b) The compensation committee should:

(1) Review and recommend to the board, or determine, the annual salary, bonus, stock options, and other benefits, direct and indirect, of the senior executives.

(2) Review new executive compensation programs; review on a periodic basis the operation of the corporation's executive compensation programs to determine whether they are properly co-ordinated; establish and periodically review policies for the administration of executive compensation programs; and take steps to modify any executive compensation programs that yield payments and benefits that are not reasonably related to executive performance.

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